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THE ECONOMIC OUTLOOK THROUGH 1986

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE, PRODUCTIVITY, AND ECONOMIC GROWTH

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

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THE ECONOMIC OUTLOOK THROUGH 1986

WEDNESDAY, SEPTEMBER 25, 1985

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TRADE, PRODUCTIVITY,
AND ECONOMIC GROWTH
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:45 a.m., in room SD-106, Dirksen, Senate Office Building, Hon. James Abdnor (vice chairman of the committee) presiding.

Present: Senators Abdnor, Symms, Mattingly, and D'Amato; and Representative Hamilton.

Also present: Robert J. Tosterud, deputy director; Charles H. Bradford, assistant director; and Dale Jahr, William R. Buechner, and Paul Manchester, professional staff members.

OPENING STATEMENT OF SENATOR ABDNOR, VICE CHAIRMAN, PRESIDING

Senator ABDNOR. The Joint Economic Committee Subcommittee on Trade, Productivity, and Economic Growth will come to order.

Mixed economic signals are making it difficult to predict the direction and the strength of the next move in the economy. I am particularly concerned about the lack of economic revival in some of our smokestack manufacturing sectors and in our Nation's rural areas.

The recovery enjoyed by most of the country has completely bypassed rural America where, in fact, the worst recession in years is taking place. I am concerned about what this rural recession and our manufacturing malaise portend for the future of the economy as a whole.

The figures on the overall economy have been very good. The U.S. economy had a dramatic 7.1 percent annual rate of real growth from the end of the recession in November 1982 through the second quarter of 1984, the fastest 18-month growth period since the Korean war. Inflation was kept under control—less than 4 percent. Unemployment fell 3.5 percentage points.

Since mid-1984, the economy has expanded much more slowly—at a 2-percent pace—and, as I noted earlier, in some sectors—notably agriculture and parts of manufacturing—it is still in recession.

The question on all of our minds is this: Is the slowdown in the first half of 1985 a prelude to recession or a pause that sets a foundation for strong economic growth later this year and next year?

We have some very distinguished experts today that can answer that question, and can enlighten us on the state of the economy as a whole.

Our first witness is the Chairman of the President's Council of Economic Advisers, and before I introduce this gentleman I'd like to ask—we're very pleased that Congressman Hamilton on my left and Senator Mattingly on my right who are very concerned members of this committee—do you have a statement?

Representative HAMILTON, Mr. Chairman, I have no statement. I would just welcome our witnesses and tell them we're delighted to have them with us and we look forward to their testimony.

Senator ABDNOR. Thank you. Senator Mattingly.

Senator MATTINGLY. I have no statement, Mr. Chairman. I just hope the panel that's coming before us today addresses just economic growth and ways to reduce Federal spending because I think those are the two key points.

Senator ABDNOR. Senator D'Amato, do you have a statement?

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. I want to thank you for conducting this important hearing. Before we begin, I would like to welcome our distinguished panel of witnesses. I would also like to congratulate you, Mr. Chairman, on your ability to assemble such a group of notable economists to discuss the future of the economy. I believe this hearing will be most enlightening.

The economy is giving off mixed signals right now. While I remain optimistic, I am increasingly concerned with the slowdown in growth during the first half of 1985. I realize the number of individuals employed in this Nation has grown tremendously in the past several years, and inflation has been held close to negligible rates, but today's flash estimate of gross national product growth of 2.8 percent in the third quarter has given me reason to inquire more about the performance of the economy in the coming year.

I realize the panel of economists will present a well informed, balanced view of where we are heading. What I also realize are the steps that my congressional colleagues must take in order to ensure the stability of our economy.

First and foremost, the deficit must be brought under control. The Senate must control the growth of Federal expenditures. While this oftentimes is easier said than done, I believe it may soon become a necessity for the survival of the economic expansion.

Second, we must avoid destructive protectionist trade policies that inhibit fair trade, as an answer to our continuing trade deficit problem. I believe there are legitimate concerns, but I also believe that protectionist proposals aimed at reducing imports to the United States are counterproductive. Actions such as this will only reduce U.S. output and employment, thus stymieing economic growth.

It is my sincere hope that your testimony today will enlighten and educate this committee.

Thank you, Mr. Chairman.

Senator ABDNOR. I thank you very kindly.

We have the Honorable Beryl Sprinkel with us, and following Dr. Sprinkel we're going to have a panel of economists, Dr. Alan Greenspan, who is chairman and president of Townsend-Greenspan & Co.; Dr. Lawrence Chimerine, chairman and chief economist, Chase Econometrics; and Dr. David Bostian, president and chief economist, Bostian Research Associates, Inc.

First, we start with Dr. Sprinkel and we appreciate your attendance here today. I think this is probably your first appearance before this committee since you've become Chairman of the Council of Economic Advisers. We are certainly looking forward to your testimony and you may proceed in any manner you wish, Dr. Sprinkel.

STATEMENT OF HON. BERYL W. SPRINKEL, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SPRINKEL. Thank you, Senator Abdnor, distinguished members of the committee, I am pleased to have the opportunity to submit my statement of the administration's views on the current situation and the outlook for the economy. I will attempt to briefly summarize my prepared statement if I may.

I welcome this opportunity to review the outlook for economic growth in the United States at this time.

The recovery of the U.S. economy over the past 2½ years has been quite strong. Employment has increased 8.1 million persons and the unemployment rate is now below the rate achieved at the previous business cycle peak. Total output has also grown at a rapid rate. U.S. goods production has grown at a near-record rate and we are now at a 25-year high as a share of GNP.

The rate of inflation, fortunately, has been sharply reduced. It's been only 2.5 percent annual rate over the past 4 months.

The slowdown in growth in the first half of this year which you referred to, Senator Abdnor, has been a special cause for concern. We think the prospects are good but further actions are needed.

In our view, it's important to reduce further the rate of growth in Federal expenditures, to reform the tax system, and to avoid policies that treat symptoms and in fact make the situation worse.

Let me review in a little more detail the current situation. We are now almost certainly experiencing an acceleration in real output and employment. The leading indicators turned up earlier this year and they have strengthened further since May and they continue to rise.

Employment was up sharply in July and continued to rise in August. Inflation has remained low. The Producer Price Index in fact has been flat since last April. Consumer prices have been rising at a 2.5-percent rate.

Last Friday's flash estimate indicated real GNP is 2.8 percent estimated for the third quarter, and in both the second and third quarter real final sales grew at a rapid rate as inventory accumulation declined.

These statistics indicate that the U.S. economy is beginning to show renewed strength and will carry forward into 1986. The administration's economic projection at present assumes a 4-percent real growth next year.

Over the last year, despite some problems, fundamental improvements have occurred. There has been a major effort underway in manufacturing to trim costs and boost productivity and these efforts have paid off. Over the last four quarters productivity has increased in the manufacturing area 3.5 percent and unit labor costs rose only 1.3 percent. The adjustment continues but seems to be largely complete.

In the second quarter productivity was up 7.5 percent annual rate as unit labor costs actually declined 2.5 percent during that quarter.

Inventory accumulation has slowed sharply over the last three quarters. Inventory sales-ratios are now quite low and given the increased volume of sales now occurring it seems to me that the low state of inventories is a positive factor for the outlook for future U.S. production.

Capital spending remains strong. Real business fixed investment is at a record share of GNP, 13 percent, but there are some problems.

The trade picture has indeed been bleak. In the first half of 1985 real net exports fell sharply. I think the adjustment is occurring and there are some reasons to believe that later on it will improve, but those adjustments are slow. It will result from a major effort to improve our competitiveness in the manufacturing sectors. Second, we have seen some decline in the dollar which will favor our exports. Third, we expect some improvement in economic growth outside the United States, and the slow growth abroad has been a strong deterrent to our sales of goods and services abroad. Finally, this week the President proposed a series of measures designed to encourage our exports.

Turning to another area, the Federal sector continues to show imbalances, from my point of view. The 1985 deficit is expected to be up by $25 billion and the rise is not due to a lack of receipts. Estimated receipts are up 10 percent this fiscal year, but total outlays are expected to be up 11 percent. Outlays, excluding defense and interest, have also increased rather rapidly, about 10 percent in fiscal 1985.

Monetary policy remains a source of uncertainty. As you know, the money supply has grown rapidly so far this year, at about a 13-percent annual rate, but there is some uncertainty about the interpretation of monetary growth. Financial deregulation has made analysis difficult. Eventually, it will become clearer but in the interim until those adjustments are complete one could expect that the usual behavior of velocity will be somewhat different in the current environment.

It's critical, I think, that the Federal Reserve take caution to pursue a risk-minimizing policy path during this period of uncertainty. The administration does not dismiss a potential serious risk to inflation control. The reduction of inflation in the past few years has been a major economic achievement and we want to continue low and even lower rates of inflation.

Well, in summary, the near-term outlook for the U.S. economy I think is quite good. Real growth is accelerating in the current quarter and inflation remains low.

Of course, this positive outlook is not a certainty. There are risks. Some of those risks are subject to our control—control by the administration, by the Congress, and certainly by the Federal Reserve—and I would like to concentrate a little on expenditure policy, tax reform, and trade policy.

First, I think the time has come to reverse the rapid rise of Federal Government spending as a share of GNP. Second, the current tax system is badly in need of reform. Reform would improve the allocation of resources, increase the incentives to work, level the playing field for capital investment, and reduce tax evasion. I certainly hope that the Congress will move forward on tax reform this year. Finally, a few comments on trade policy. It's clear that the various proposals aimed at restricting imports are without question bad for the Nation. Such actions would reduce national wealth. They would reduce our income. They would raise our costs. They would reduce our employment gains.

The rise in the trade deficit has generated concern, but also I think some misinformation. Some people argue, for example, that the United States is clearly becoming a service economy and, yet, if you look at real U.S. goods production it's at a 25-year high with respect to the total economy.

Some people say that imports are reducing employment in manufacturing and, yet, there are studies that we have reviewed showing no correlation between changes in employment and changes in net imports for 73 industries in manufacturing.

Some have pointed, of course, to the fact that the United States now has incurred a net debt position with respect to the rest of the world. I think it's important to maintain some perspective with respect to the fact that we are becoming a net debtor as a total nation, not as a government but as a nation. We should recognize, for example, that the U.S. nominal stock of tangible assets is now estimated at something like $13 trillion.

I did an exercise recently—asked my staff to assume that we have—I hope this isn't true but I took a worst case—$100 billion current account deficit running for 10 years. What would be the ownership of foreigners of U.S. assets, and it's about 5 percent of our assets. So it's important to keep the issue in proper focus, but I do not want to create the impression that I think the trade deficit is no problem. It is a problem and we are addressing it.

Some portion of the inflow of capital from abroad, of course, is due to financing the requirements of the Federal Government. We do not generate sufficient savings to finance our very large fiscal deficit along with the investment that is occurring in this country and clearly the solution is to slow the growth in Federal expenditures.

The decline in real exports has been due to several factors. Certainly one of them is the strength of the dollar. Also, the continued weakness in other nations' economies is a factor and in some cases restrictions on U.S. exports are a factor. And the President has made very clear that he wants to keep our markets open but to exert increasing influence on markets abroad to make sure they remain open for U.S. exports. He has proposed a program aimed at opening foreign markets.

We know that protectionist proposals aimed at reducing imports to the United States are counterproductive. We know that enacting such legislation would have a very unfortunate effect on U.S. output and employment.

In closing, let me summarize the main points concerning our policies and our prospects.

It's very easy in the current environment to be optimistic about the economy as a whole under a set of stable and constructive policy assumptions. I have emphasized three necessary features of sound economic policy.

First, restraint in the size of government is required. Without restraint, we will see a steady erosion of incentives to produce and continued uncertainties in capital markets.

Second, we must press ahead on tax reform. An efficient tax system would provide the basis for sound, long-run economic decisionmaking and increase economic growth.

Third, we need to recognize protectionist trade policy for what it is—a bad policy that is clearly detrimental to the Nation as a whole. We need a positive trade policy that opens foreign markets, not closes U.S. markets.

Thank you for providing me with the opportunity to outline my views on current economic conditions and some major policy issues.

[The prepared statement of Mr. Sprinkel follows:]

Prepared Statement of Hon. Beryl W. Sprinkel

Chairman Obey, Senator Abdnor, distinguished members of the Committee, I am pleased to have the opportunity to submit this statement of the Administration's views on the current situation and outlook for the U.S. economy.

I welcome the opportunity to review the outlook for U.S. economic growth at this time. The recovery of the U.S. economy over the past two and one-half years has been very strong. Employment has increased 8.1 million and the unemployment rate is now below the rate achieved at the previous business cycle peak. Total output has grown at a rapid rate. Contrary to the popular perception that economic growth has been limited to the service sector, U.S. goods production has also grown at a near record rate. U.S. goods production is now at a 25-year high as a share of GNP. Over the same period the rate of inflation has been sharply reduced.

Overall the record for U.S. economic performance in the current expansion has been very good. However, throughout this period and especially in the first half of 1985, concerns about the economy and economic policy have been raised. The slowdown in growth in the first half of 1985 has been a special cause for concern. Clearly we can do more to improve economic efficiency and growth prospects. We need to reduce growth in federal expenditures establishing a sound fiscal position. We need to reform the tax system. However, we should avoid policies that treat symptoms, but reduce long-run growth prospects.

Let me first discuss the current situation and then the outlook for the economy through 1986 and the risks we face.

After a slowdown in U.S. economic growth over the last four quarters, we are now experiencing an acceleration in real output and employment. The index of leading indicators turned up in May and has been rising steadily through July. Employment turned up sharply in July and continued to rise in August. Inflation has remained low; the producer price index has been flat since April and consumer prices have been rising at around an annual rate of 3 percent. Last Friday the Department of Commerce released "flash" estimate of third quarter GNP growth. The flash estimate indicates real GNP is growing at an annual rate of 2.8 percent in the third quarter compared with the second quarter estimate of 1.9 percent. In both quarters, real final sales grew at a rapid pace as inventory accumulation fell.

These statistics indicate that the U.S. economy is beginning to show renewed strength that will carry forward into 1986. The current Administration economic projection assumes 4 percent real growth in 1986. This projection has been labeled optimistic by some. I do not share this view. Over the last year fundamental improvements have occurred that leave the U.S. economy well placed for a resumption of strong growth.

Over the last four quarters, employment in manufacturing slowed sharply. In part, this slowdown reflected a response to reduced overall activity. However, it is also clear that a

major effort was underway to trim costs and boost productivity. That effort has paid off -- over the last four quarters productivity in manufacturing increased 3.5 percent and unit labor costs rose only 1.3 percent. That adjustment appears to be largely complete. In the second quarter productivity rose at an annual rate of 7.5 percent and unit labor costs fell 2.5 percent. Preliminary data for August show employment, hours, and output rising in manufacturing.

Production to build inventories slowed sharply over the last three quarters. Nonfarm inventory accumulation averaged $21 billion in real terms in 1984, but by the second quarter of 1985 inventory accumulation had fallen to $5 billion. These cuts in production for inventories leave inventory-sales ratios at low levels. Typically inventories build up prior to and during a slowdown in economic activity. The tight control over inventories in the current period is a positive factor in the outlook for U.S. production. In a longer run context, the trend decline in inventories relative to sales since 1981 may reflect the adverse effect of relatively high effective tax rates on inventory investment. In so far as this is the case, the situation is inefficient. As you know, the current tax reform proposal would go far towards eliminating these differentials.

Real business fixed investment is at a record level (13 percent) as a share of real GNP. The last survey of investment planned by business indicated real growth of 5.8 percent over

1985. Growth at this rate will drive the real investment share to even higher levels. These additions to the capital stock will make our work force more productive and competitive in international markets.

Over the last six months the trade picture has been bleak. In the first half of 1985 real net exports fell sharply. Exports fell $9.2 billion in real terms from 1984 fourth quarter to 1985 second quarter and imports rose $11.3 billion. Real merchandise exports fell $4.4 billion over the first half with exports of agricultural products accounting for $3.9 billion of the decline. Real merchandise imports rose $13.4 billion. The data for merchandise trade in July showed stable nominal exports and a sharp decline in imports following four months of increases. While one month's data provides slim evidence, other factors are moving in a positive direction. First, as discussed earlier, a major effort to improve competitiveness has been underway in the manufacturing sector. Costs are contained, productivity is up, and relative prices are down. Second, we have seen some decline in the dollar. This reduces U.S. export prices on world markets. Third, we expect some improvement in economic growth outside the U.S. Finally, this week the President has proposed several measures designed to encourage U.S. exports.

The federal sector continues to show imbalances. The FY 1985 deficit is expected to be $25 billion higher than the FY 1984 deficit. This rise is <u>not</u> due to a lack of receipts.

Preliminary estimates put receipts growth at about 10 percent in FY 1985. But total outlays are expected to be up 11 percent. Some blame the increase on defense and interest outlays and claim that other programs are being squeezed. Well, that's just not true. Outlays excluding defense and interest have increased about 10 percent in FY 1985. At the same time, the inflation rate has fallen 1 percent or more. The fact is, growth in real outlays excluding defense and interest payments have accelerated rapidly in FY 1985.

Monetary policy remains a source of uncertainty. So far this year, the money supply has grown at a compound annual rate of more than 13%. Recent declines in velocity, however, are symptomatic of the uncertainty about the interpretation of recent money growth. It is possible that the financial deregulation that has occurred in recent years has altered the fundamental relation between M1 balances and public spending habits. It is not possible at this point to conclude whether the unusual behavior of velocity is transitory or permanent. Uncertainty will remain about the interpretation of the monetary aggregates until enough time has passed for velocity behavior to settle down to its historical pattern or for a new pattern of velocity behavior to emerge.

In the face of that uncertainty, it is critical that the Federal Reserve take caution to pursue a risk-minimizing policy path. The Administration does not dismiss out of hand the serious risk to inflation control associated with the money

growth that has occurred so far this year. We consider the reduction of inflation to be a major economic achievement the far-reaching economic benefits of which -- in terms of economic growth and financial market stability -- we are only beginning to see.

In summary, the near-term outlook for the U.S. economy is good. Real growth is accelerating in the current quarter and inflation remains low. Employment is rising rapidly and the unemployment rate is down. A number of positive developments are in place or underway that indicate growth in the 4 percent range is sustainable for sometime to come.

Of course this positive outlook is not a certainty. There are risks and uncertainties associated with any forecast. However, we are also fortunate in that much of the risk is subject to our control. Good policies will yield good results. At this time we have before us three major economic policy issues. They are expenditure policy, tax reform, and trade policy. If we move to control expenditure growth, reform the tax system, and avoid destructive protectionist trade legislation, then I expect a strong economic performance.

The Congress has before it a series of appropriations bills. The time has come to reverse the rapid rise in Federal Government spending as a share of GNP. Restraint is required on all appropriations at this time. The acceleration in outlay growth in FY 1985 must be reversed. It is also important to keep the incentive effects and other non-budgetary costs of

federal programs in mind. Reducing the budget costs of a program several billion dollars by increasing consumer costs by equivalent or larger amounts is bad policy.

The President has sent up a tax reform proposal for your consideration. The current tax system is badly in need of reform. Piecemeal revision of the tax code over the years has lead to progressive reductions and distortions in incentives and generally rising tax rates. The time has come for a general review and reform of the tax code.

The CEA has reviewed the President's proposal and we strongly support the recommendations. We have concluded that this reform would improve the allocation of resources, increase the incentive to work, level the playing field for capital investment and reduce tax evasion. I realize this is a strong endorsement and I do not give it lightly.

Some have said that the President's proposal for tax reform will not be considered by Congress this year. I would consider such a course of action (or better yet inaction) incomprehensible given the universality of professed concerns over the state of the economy.

Finally, I want to discuss trade policy. It is clear that the various proposals aimed at restricting imports are, without question, bad for the Nation. Restrictions of imports may benefit special interest groups in the short run. However, beyond a shadow of a doubt, such actions would reduce national wealth, income, and employment.

The continued rise in the trade deficit has generated a great deal of legitimate concern but also large quantities of misinformation. For example: Some people say the U.S. is becoming a service economy. In fact, real U.S. goods production as a share of GNP is at a 25-year high. Some people say that imports are reducing employment in manufacturing. In fact, the latest detailed study I have read finds no correlation over the 1980-84 period between changes in employment and change in net imports for 73 industries in manufacturing. Some people point to overall declines in goods producing employment as a sign that the U.S. is "deindustrializing." In fact, goods producing employment has been declining as a share of total employment over the whole postwar period. This trend reflects rapid productivity growth, not declines in goods production. Finally, some people are now making much of the fact that the U.S. net debt position with the rest of the world has just gone negative. On this it is important to maintain some perspective. First, the U.S. nominal stock of tangible assets is about $13 trillion. A net capital inflow of $100 billion a year, if maintained for ten years, would yield net foreign ownership of U.S. capital of about 5 percent. Net capital inflows in large part reflect a general worldwide view that the U.S. is a very good prospect for profitable investment. However, some portion of the inflow is due to financing requirements on the Federal Government budget deficit. The solution to this problem is clear -- reduce the growth in federal expenditures.

On the other hand, clearly there are legitimate concerns. The decline in real exports over the first half of 1985 is an unwelcome development. The strength of the dollar and continued relative weakness in other nations' economies are major contributing factors. On the other hand, we could be doing more. For example, restrictions on the export of various commodities produced in the U.S. are not helping the situation. High domestic price supports for agricultural products that, if continued, will prevent a rebound in agricultural exports. Large agriculture export subsidy programs by our trading partners are an equally serious problem. The President has proposed a program aimed at opening foreign markets. We know that protectionist proposals aimed at reducing imports to the U.S. are counter-productive. We all know that enacting such legislation would reduce U.S. output and employment.

In closing let me summarize the main points concerning our policies and prospects. If our economic policies are sound, our prospects are excellent. It is realistic to expect continued economic expansion consistent with further reductions in unemployment.

It is easy to be optimistic about the economy under a set of stable and constructive policy assumptions. I hope the policy assumptions are correct. We have made great progress over the last few years, but the risk of poor policy choices remains.

I have emphasized three necessary features of sound economic policy. First, restraint in the size of government is required. Without restraint we will see a steady erosion of incentives to produce and continued uncertainties in capital markets. Second, we should press ahead on tax reform. An efficient tax system would provide the basis for sound long-run economic decisionmaking and increase economic growth. Third, we need to recognize protectionist trade policy for what it is -- bad policy that is clearly detrimental to the Nation as a whole. We need a positive trade policy that opens foreign markets, not closes U.S. markets.

Thank you for providing me with the opportunity to outline my views on current economic conditions and policy.

Senator ABDNOR. Well, thank you, Dr. Sprinkel. We were very eager to hear from you. We have great respect for your thoughts and judgment on the economy.

For members of the committee, we will start off with 7 minutes of questions so no one will monopolize the time.

Dr. Sprinkel, I don't want you to think I'm blind and only see one side of the economy—and you probably expected that this was going to happen—I'm sure reports have come back to you before—but I need not tell you that while those views of the past few years of growth in GNP and the growth in productivity and the economy as a whole look bright and is bright in most places, I guess, but there's a large land area of this United States that wouldn't know what you're talking about if you went out and had a discussion with groups of people out in my country. I'm not just talking about farmers. I'm talking about communities out there, the towns and some fairly respectably sized cities, who are directly affected.

Tell me something. When 75 percent of the people live on 2 percent of the land, I know how politicians react, but how do the economic advisers and economists in general react? Their reactions seem to have quite an influence on predictions. I've had panelists in here before—we've had labor figures come in regularly every month. They admit readily that it really doesn't affect at all what is going on in the other parts of the country in rural America.

How would you respond to that and what concern should that be? I know it's of great concern to me because I come from there and I'm entirely surrounded by it, but I am not just talking about South Dakota. I'm talking about all the other rural areas and there's hardly a Member of this Congress who doesn't have some, even in States like New York and California, and they're hurting. They are suffering severely. My concern is no one at the top is worried about them.

Mr. SPRINKEL. Senator Abdnor, I share your concern because I come from there, too. I was born on a small farm in Missouri. I was reared on that and a farm in a nearby community. I went through the Great Depression as a farmer. My father lost his farm in that period. I used to drive mules and many years later tractors. I just came back from a visit to the Midwest and I know what difficulties are being inflicted on the agricultural community and I am indeed very concerned, as is President Reagan and the rest of the administration.

We believe that those problems are not due solely to a few irresponsible farmers borrowing too much money. That contributed to some difficulty, but it's also due to policies that we have pursued as a nation which has caused great problems in the agricultural community.

It's in our interest to try to move toward a set of agricultural policies that would provide help for the future and not continue to see them mired in debt, with low prices, low incomes, and inability to service their debt.

As you are well aware, we have sent to the Congress a set of principles that we believe would be helpful in moving out of this very serious problem in the farm areas. For example, we are not going to walk away from the farmers because Government is partly responsible and we think that commodity price supports must be

established at levels that allow export-dependent commodities to compete in world markets. We are losing our share abroad partly because of the high dollar but also partly because of our Government policies that make those products noncompetitive.

We believe that income benefits should be targeted to legitimate family farm operators, that we have a responsibility to help them through this difficult adjustment.

We do, however, believe those income supports should be gradually reduced each year. Dairy price supports certainly should be reduced each year as long as the enormous surpluses exist.

We think that acreage reduction programs should be phased out. We want to move back to a market-oriented farm situation, not a Government-dictated farm arrangement.

Farm policy also cannot violate fiscal responsibility. We do have constraint on the budget and we hope to work with the Congress such that we can have a program that will move us toward market orientation at a price and cost that the American taxpayer will be willing to absorb.

Senator ABDNOR. Dr. Sprinkel, that's all well and good. I suppose if that had been our approach 5, 7, or 8 years ago, that might be. But let me tell you. I just spent 5 weeks in South Dakota. I made over 70-some appearances. I spent 1 week at the State fair. If you want to know what's going on in life and what condition people are in, go to a State fair where you're a target for them because you're standing there and they see you and they want to come up and tell you.

People, who I never thought would be suffering, are on the brink of going under. I know these people personally. I never dreamed that they could be in that kind of trouble.

Any kind of a sudden pullout of price supports and the situation would worsen. Maybe that's the disease—it's there and it's like taking that person off alcohol and it's got to be slowly made better. I don't know any kind of a free market in this country, that is as productive as our farmers are—and they're the most productive people in the world—there isn't any other business in this country that can touch it. But when you've got Argentina getting ready to buy 150 metric tons of wheat at $2 a bushel—I'm a wheat producer, and I'm telling you there isn't anybody in this country that's going to produce wheat for $2 a bushel.

And I agree with you totally that this problem has come about because of Congress and administrations of the past, particularly with this kind of a deficit. There was inflation raging at 12 and 13 percent. It was those high-interest rates at 20 percent that really buried these people. But when prices today are less than they were after World War II, when I was young, there's just no way in the world that they can keep up with it. No one can tell me this free market is great until a lot of things happen. It's just too much for these farmers and other people to try to absorb and it's not their fault. Maybe some of them overborrowed. But let me tell you, the bankers are just as responsible and right now—we're not just talking about farmers. We're talking about the banking system out in those rural areas. It's not just one or two of them that is in trouble. We heard about Continental because it was one bank that may have affected the whole world. As more farmers are being put out

of business, and more land is coming on the market, the land value continues to drop and the price of land goes down. I do not think we've even begun to see where it's going to level off. If it goes much lower, there are going to be a lot of banks, along with our Farm Credit System, going down the drain.

And I don't think you can look at this as a normal cure for taking care of the problem. I think I've used up my 7 minutes.

Mr. SPRINKEL. I share your concern, sir.

Senator ABDNOR. Thank you. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Dr. Sprinkel, I'd like to focus first on your outlook projections and, of course, the way I read your statement it's quite optimistic. You talk about real growth accelerating, employment rising, inflation down, and the near-term outlook for the economy in your words is good.

Now you contrast that with the testimony of a couple of the witnesses that are going to follow you. Mr. Greenspan, for example, concludes that it's certainly premature to predict a recession in the latter months of 1986 and it's rather interesting to me that he even puts that word into his statement because we don't usually like to talk about recessions. He's not predicting one, but he's beginning to talk about one and then he says that projection of continued expansion is inappropriate, in his words, at this stage.

Then I have the statement also of Mr. Chimerine, who will testify later, and he too seems to be a little more pessimistic than you do. He talks about the relatively slow and erratic growth that the U.S. economy has experienced. He suggests that some of the recent statistics overstate the strength of the economy at best and that only a very modest pickup is now taking place.

Then he throws in this word recession too, interestingly enough. While a recession is not likely between now and the end of 1986, sustained very strong growth is equally unlikely.

So reading these statements, then, you kind of get a very different sense of how you assess the economy and I'd like you to direct some comments to this. You're the optimist. I guess they're a little more pessimistic than you.

Why is that?

Mr. SPRINKEL. Well, I'm not certain, however, I'm well aware of the fact that when you have three economists with different backgrounds and somewhat different ways of looking at the world, they may well end up with different answers.

I have done my best since joining this administration to make certain that I keep my mind clear and try to think like I thought when I was on the outside and not get inflicted by the Beltway disease. And we went through a very careful, methodical review some 2 or 3 months ago looking at the evidence as to whether or not the slow progress that last part of last year and the early part of this year and up until just a short time ago was likely to continue or were we building up for renewed expansion. We didn't know that answer until we looked at the data and I can tell you what we looked at. It's the same techniques that I've used for a period of years in the private sector and I checked people in the private sector to make certain that I wasn't losing my sense of impartiality.

We looked, for example, at what had happened to monetary policy because that is not the only but it's an important factor that shows what happens in subsequent periods, and we've had rapid expansion in money from last fall up until the time we were doing the analysis and even up to now, in contrast to very slow growth from last spring to last fall.

That in the past has inevitably been followed by expanding spending, output, and production.

Second, we looked at the leading indicators. They usually being rising after money growth goes up and that indeed happened again. They started up in January and I think with the exception of 1 month have been rising each month since.

We looked at various imbalances that might exist that could make this time different, such as is there obviously a big inventory overhang and it's difficult to answer that question precisely, but it was very clear that inventory-sales ratios were low and that if sales were starting up it would not be a problem.

We looked at interest rates. Interest rates frequently prior to a recession, rise and shut off demand for housing and other segments. This time interest rates have been coming down.

Based on this and much more detailed analysis, it was our view and it remains our view that the economy will begin expanding shortly.

Now since we made that forecast, there's a lot of evidence to support the fact that it is moving up at a good clip and no one knows how much.

Representative HAMILTON. Do you think the growth is sustainable at 4 percent for some time to come now?

Mr. SPRINKEL. I think it is sustainable provided we keep our proper policies that will provide that support.

It's important also to recognize that I should not nor should others I hope overclaim for economic analysis. In my opinion, short-run predictions are good for about 6 to 9 months out and if you try to push them further than that you're imagining things.

Representative HAMILTON. Let me ask you specifically about monetary policy. M1, of course, has been growing at a fairly rapid rate. I think the figure is well above 10 percent. You're usually identified as a monetarist in your economic views.

What do you think about the current pace of money growth? Is it appropriate?

Mr. SPRINKEL. Well, as I indicated in my testimony, there are some real problems in analyzing that series at the moment and I share some of the concerns expressed by the various officials in the Federal Reserve. We know, for example, that M1 has for some time now included Super NOW and NOW accounts which have a saving component and probably a considerably small velocity, to use some terminology that economists use, and whereas we used to know all about the M1 had a secular rise of 3 percent or so a year there's reason to believe that it will be less than that and none of us know for sure how much less.

Representative HAMILTON. How do you feel about it at the present time, given all these factors? I understand it's a pretty tricky business, but is it an appropriate level of growth in the money supply?

Mr. SPRINKEL. I think it depends on what happens to policy in the future. If we were to continue at accelerating rates of growth in money, which I don't expect and I do not believe the Federal Reserve expects, this could lead to very serious inflation. On the other hand——

Representative HAMILTON. Let me tell you how I read your answer. The way I read your answer is that you accept the present rate of money growth for the time being, obviously depending on what happens to the policy for the future you would make adjustment; but at the present time you think that rapid growth is appropriate.

Mr. SPRINKEL. As you know, the Federal Reserve is an independent agency. We meet with them frequently. They determine their policy and we must accept it. I was merely pointing out that some of the concerns down the road that if it were to continue at this rate I'm sure all of us would be concerned about emerging inflation. On the other hand, if there was a sudden squeeze on money, then we could be concerned about a serious slowdown in the economy in 1986. But neither of those two things have happened.

Representative HAMILTON. Mr. Sprinkel, I'm merely trying to get an answer.

Mr. SPRINKEL. I understand.

Representative HAMILTON. That's all I'm trying to do. I want to try to understand whether or not you think present money growth is appropriate.

Mr. SPRINKEL. It is not appropriate for me to second-guess the Federal Reserve because I don't know what they're going to do in the subsequent months and we understand the difficulties and we are working with them in the analysis, and we will watch very carefully the policies pursued in months ahead.

Representative HAMILTON. You see, it's a very puzzling thing for the ordinary person to appreciate this great gulf between fiscal policy and money policy and we all know that those are the two great ways that the Federal Government impacts the economy. One gets the sense when he talks to you or if he talks to high officials of the Federal Reserve, on the other hand, that you operate in two different worlds, that you don't try to interrelate, coordinate, harmonize fiscal and money policy.

Now here you have a rather remarkable course, it seems to me, by the monetary authorities—10 percent growth—and you're exceedingly reluctant to make any comment about that and yet it has profound impact for the economy and it could help or destroy fiscal policy, no matter how well it might be managed.

So that's my reaction to this and I appreciate the restraints that operate on you as chairman of the Council of Economic Advisers.

Thank you, Mr. Chairman.

Senator ABDNOR. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Dr. Sprinkel, we saw a dramatic drop in the value of the dollar on Monday. Do you attribute that fall to the announcement Sunday by the Group of Five discussion and the anticipated action of the intervention of the Federal Reserve?

Mr. SPRINKEL. Probably. I'm not certain.

Senator MATTINGLY. What do you think the results of that will be?

Mr. SPRINKEL. There was no direct statement that I read and I read all the material about the degree of intervention, if any, and, of course, central bankers and Treasury officials do not comment and we do not comment on intervention, whether it's happening or how much, and I in fact do not know. But I think there was some belief in the marketplace that intervention might occur and if you are a trader in currencies or if you are a businessman planning to take action in that market on one side or the other there's a great incentive to not run into competition with the central bank, which in the very short run can be powerful. So there was a withdrawal.

Senator MATTINGLY. What do you think the anticipated results of that would be?

Mr. SPRINKEL. Well, the important thing that developed from my point of view was a list of policy statements by each of the governments indicating that they were continuing to work diligently toward greater economic convergence. You may remember that beginning in the Versailles summit there was an agreement since that time that the G–5 would meet periodically, compare results, discuss each other's policies, make suggestions in private, and make efforts to bring down what then was a serious inflation in some countries and also to bring up economic growth which was a serious problem in some nations.

Senator MATTINGLY. What impact do you think that will have on trade?

Mr. SPRINKEL. I think this discussion has been helpful over the years. In any event, there has been greater convergence. That is, inflation rates have come down even in the major countries that had extremely high inflation. In the United Kingdom, the peak I believe was 23 percent. France was very high. Italy was very high. They are moving down toward sort of single digit and in some cases very low single digit inflation rates and growth has improved.

It's our view, Senator Mattingly, that one of the major deterrents to growth in our exports is slow growth, especially in Western Europe but it also applies to Latin America and certainly Africa, not so much to the Far East. We have initiated through several forays, including the G–5, intensive discussions of what the Europeans refer to as structural rigidities which slow their growth. They are moving on that front and I'm optimistic.

Senator MATTINGLY. Let me intervene. What I'm trying to get to, though, the bottom line, is what impact you think that will have on U.S. trade and how soon?

Mr. SPRINKEL. That's the bottom line that I'm interested in as well. We first have to know whether statements are followed by action. Statements are cheap. They're easy to make. But it's important that those statements by central bankers, Treasury officials are pursued in a way that it does lead to an expansion in economic outlook over and above what's happening now and I don't think there's any quick fix. I do not believe that politically they can solve all these rigidities in a very short period of time, but they are aware of them, they're moving on them, and as their output improves—and it is improving in Western Europe now, in most countries. It's not up to par, in my opinion—it will increase the demand

for our exports. So that was an important portion of the President's white paper which was released earlier this week to look at what is happening abroad and recognize that differential rates of growth in the United States vis-a-vis the rest of the world has been a major contributor to our trade problems. We have grown more rapidly. We have encouraged imports. They have grown less rapidly and our exports have not enjoyed good markets.

Senator MATTINGLY. Well, maybe I didn't get the drift of your answer.

Let me ask you another question. In reference to agriculture, it seems to me that agriculture is really to a great deal dependent upon government policies in trade and government policies in agriculture. Knowing full well that it's difficult to pass a 4-year agriculture bill, I would not call a 4-year agricultural bill good public policy.

Has there been any thought by you or recommendation by you possibly of trying to convince the President maybe of trying to pass 8- or 10-year agricultural policies—a bill rather than a 4-year bill in order to phase down what I think everybody wants phased down in agriculture, in trying to come forth and say let's pass an 8- or a 10-year bill other than a 4-year bill which anybody walking the streets in this town knows is not going to give stability to the agricultural sector?

Mr. SPRINKEL. Well, I have not given thought to a 10-year possibility primarily because I'm well aware of the fact that we cannot bind future administrations nor can you bind future Congresses.

Senator MATTINGLY. You bind them with a 4-year bill.

Mr. SPRINKEL. Even that can be changed. You can change the bill again next year. We have talked about the direction that we would like to go over the next few years. That is, to improve the state of the agricultural economy it's very important that we restore competition. That's why we would like to see some decline in the dollar as a result of expansion abroad. We would like to see farm prices again competitive, but we know that income supports must be provided to farmers in the transition. So we are talking about not a sudden change but a gradual adjustment over time.

But to answer specifically have we thought about an 8- or 10-year bill, I have not and I have not heard it discussed in any of the policy forums that I have participated in.

Senator MATTINGLY. It seems to me that's part of our policy.

Let me ask you this then. Are you going to recommend to the President on appropriation bills that come out of the Congress, the Senate specifically, that if they are over the mark that he veto them? I mean, I would hope that you would.

Mr. SPRINKEL. That has certainly been my view and it's the view expressed by the President. It seems to me that he's made that about as clear as it can be made.

Senator MATTINGLY. Well, I don't think he has because I haven't seen a veto for quite a while on an appropriation bill and I just wondered if, irrespective of the bills over $25 million—in this place, $25 million isn't much—to everybody else in the United States it is, but is there any consensus in the Cabinet to say that if these appropriation bills come across there, are we going to veto them?

Mr. SPRINKEL. There is a consensus and that consensus is headed by the President. That is, if we cannot stick within the guidelines agreed between the administration and Congress when the appropriations bills come down the President has indicated he will veto them. And I see great expressiveness in his eyes when he says that and therefore I believe him.

Senator MATTINGLY. I am here to endorse that and I hope that it happens. Thank you. My time is up.

Senator ABDNOR. Thank you, Senator Mattingly.

Senator D'Amato stopped in. He has to preside at 10:30 and said he's sorry he couldn't be here but I think he's going to try to return. I'm sure we'll probably have the other panel by then.

Let me follow through on spending. I understand that very well and I have been disappointed with some aspects of the budget resolution that we finally adopted.

Do you think that the budget resolution adopted prior to the August recess will do much toward easing the trade situation and helping the economy as a whole?

Mr. SPRINKEL. Well, it certainly is a step in the right direction and it's a serious step in the right direction. It required compromise on both sides and if we can hue to that arrangement there is a good possibility that if we can sustain reasonable economic growth over the next few years that we can gradually pull that deficit down as a percentage of GNP from something on the order of 5.5 percent down toward 2 and eventually to zero.

Senator ABDNOR. Well, there's been growth—astounding growth as we all said here earlier. That didn't do much toward holding any kind of deficits down and bringing an improvement in the situation. Do you really think we're going to make the kind of reductions we need to make if we're not going to cut defense and we're not going to cut the COLA's? If I remember all the figures right, defense is up around 29 percent of our dollars, the COLA's are 35 percent of the budget cost, the interest on debt I think is 13.5 percent and I hear some people say it is higher. You take that block of expenditures and say they're outside the cutting zone, do you really think we can get around to making the reductions necessary to do the things you want to do?

Mr. SPRINKEL. I do if we put our minds to it. The President, for example——

Senator ABDNOR. Well, how?

Mr. SPRINKEL. The President made a major concession in terms of an increase in defense expenditures and he's hopeful that the Congress will stay to the agreed concessions that they made on nondefense programs. There is no quick fix. I don't want to suggest that, but I think it's time that we got on that track and stayed on that track because as we gradually reduce the deficit as a percentage of GNP it will become a less disturbing factor in the trade area as well as a less disturbing factor in the money market area. And I think it's critically important that we work jointly together to achieve that or even a better goal.

Senator ABDNOR. Well, I agree. I don't think anybody is going to argue with that. Frankly, a number of us made some very major and very difficult votes. We're going into an election period I'll tell you and it wasn't exactly the most pleasant thing to do. We had to

be pretty dedicated to do it. We've had the pins knocked out from under us. I think that if we're going to leave that big a percentage of the total budget and say you can't touch it, we're kidding ourselves. I don't mean cut, we're just trying to hold the line. If we can't hold that down, I think it's almost like a time bomb which could take off and this really bothers me.

Going back to agriculture, I think that's the key to it, to some way get this thing in line. If I could do one thing for those people, it would be to get their interest rates down and quite a bit down. Some of them are paying 15 percent yet. I would get it so that they could have a fair break on trying to carry on foreign trade when 40 percent of what they produce has got to be sold overseas.

Tell me something. I'm all for trying to bring our dollar down, and our currency more in line with the other countries, and would do anything I could to help bring that about, but I've been warned by some people that we can't do that too fast or we're going to lose all these foreign investments, which are financing our deficits in Government and helping to provide the kind of capital we need for expansion.

Is that true? I never had those figures. What do we depend upon from other countries to do these things?

Mr. SPRINKEL. In terms of foreign ownership of our Federal debt—and I believe that's your question——

Senator ABDNOR. Yes.

Mr. SPRINKEL. I left Treasury a few months ago, but when I left they owned 14 percent—they cumulatively owned 14 percent of our Federal debt. We owned the rest of it and more recent periods still showed around 14 percent. So they don't own most of it. They own a small percentage, but they own some of it.

Senator ABDNOR. What would we do if they started to go elsewhere? What if we got our interest rates down and what if our dollar came more in line? They not only would quit investing but aren't they likely to take some of their investments out?

Mr. SPRINKEL. Well, I hear of scare scenarios like that and I can imagine that could happen and let me tell you how it could happen. If we were to pursue highly improper economic policies such as policies that led to rapid inflation and soaring interest rates that led to higher taxes that led to less incentive to invest that led to no concern about incentives, if that were to happen, the money would rush out of this country. We are not going to pursue those kinds of policies, with the help of the Congress and the Federal Reserve.

Our objective is to improve growth, to improve profits, to improve incentives to hire and create jobs, and so long as we do that, I do not expect that scare scenario to develop.

I would hope that as prospects improve abroad that some investors will tilt their decision toward a little less investment in the United States and a little more in Western Europe and when the Japanese make further progress, for example, in opening their capital markets—and they have made considerable—and opening investment potential, that some of the decisions would be made to invest there. So I think markets adjust gradually—provided we have the right policies and we want to keep those policies.

Senator ABDNOR. People are going to have to start saving a little more in this country.

Mr. SPRINKEL. That would help. It's very difficult to achieve.

Senator ABDNOR. Talking about how sensitive markets are, this one-shot deal on Monday when the five nations were talking, and the following day a pickup in markets—soybeans up 14.5 percent and wheat was up 3.5 or corn I think. I guess it's probably gone the other way now because I understand the dollar has leveled off and the one-shot deal is over. But that just tells you what effect it could have guess if we had a steady goal in mind of what we're striving to do. I'm just wondering if we really got on that course if those in the know-how and those in control would let it happen. There are a certain amount of people in this country who would be very concerned about this dollar currency dropping and some people are concerned about interest dropping because they find it a pretty good place to put their money. There are a lot of factors that get into this.

Let me ask you—the monetary policy can be used to affect the business cycle in the short run and prices in the long run. Congress presently requires the Federal Reserve to answer both for business cycle and price stability goals. But what problems are created by this dual responsibility for the Federal Reserve?

Mr. SPRINKEL. Would you repeat that?

Senator ABDNOR. I'm talking about the two-pronged thing here. There are those who think you can affect the business cycle in the short run and prices in the long run and Congress requires the Federal Reserve to answer to both the cycle and price stability goals. This is a very difficult thing to try to do, is it not?

Mr. SPRINKEL. Yes, it's difficult, but from the very beginning the Reagan administration has expressed a clear preference with respect to each of those factors, both the effect on the business cycle in the short run and inflation in the long run.

We believe that to achieve, to make the maximum contribution, the Federal Reserve should have stable monetary growth, meaning by that that it would not unduly interfere with cylical developments, but it also should permit money to grow at a rate consistent with continued declines in inflation rates over the long run.

So, in my judgment, moderate increases in money at stable rates of growth will serve both of those aims.

Senator ABDNOR. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

I want to get clear in my mind what that agreement was that the Group of Five reached the other day. Are we now intervening in the markets or did we agree to intervene? What was the agreement with regard to intervention and what has happened?

Mr. SPRINKEL. There was no specific statement made publicly as to how much or when intervention would occur. There was a statement that when it was desirable to do so they would cooperate. When I was there, the U.S. Treasury never commented on the process when it was underway or when it wasn't underway. The important thing in the longer run was the agreement on policies to work toward further convergence and greater convergence and greater growth abroad. I think that is the fundamental issue. I

can't comment because I do not know what's happening in the way of intervention.

Representative HAMILTON. The whole interpretation of that meeting in the public press has been that the Reagan administration has now changed its posture with regard to intervention and is much more likely to do so and to do so in a larger way. Is that an incorrect interpretation?

Mr. SPRINKEL. I can't answer the question because I wasn't at the meeting. I think Secretary Baker would be very pleased to respond to it. Our basic view has been that on occasion we would cooperate on intervention and we have done that ever since I have been in this Government.

Representative HAMILTON. But usually you've done that when there are disorderly markets. That's been the understanding.

Mr. SPRINKEL. That's correct. And there were no references that I could find to disorderly markets in that statement.

Representative HAMILTON. Then with regard to the other economies, Japan, Germany, France, and so forth, the Group of Five said they wanted to increase their economic growth. What are we suggesting that they do in order to increase their economic growth?

Mr. SPRINKEL. Let me first make one brief statement about what we're not suggesting because it's frequently misunderstood.

We are not suggesting major massive demand stimulus which would inevitably lead to sharp inflation, higher interest rates, stagnation from which we emerged. It would be very foolish to operate for short-run gains on that front with the possibility of destroying the longer run prospects.

What we are urging is that they work hard at letting their markets work better. This means in many cases further deregulation. They use a word—the Europeans use a word called structural rigidities, and this refers usually to government rules and regulations that inhibit demand and supply forces from working. For example, in labor, which is their biggest problem—not their only—most of those countries have very high income supports for the unemployed designed to soften the cost of the unemployed and we understand that. We have income supports as well. But theirs tend to be much higher and also last longer. So it reduces the incentive on the one side to get a new job, but even more difficult is the fact that they make it very costly in many cases to hire additional workers and they do that by saying:

> If you have a worker, you cannot lay him off if your demand declines. You must first get approval by local governments, by central governments, and if you finally receive approval to lay them off, then you have a very large settlement.

So what has happened, unfortunately, in Western Europe, they have not created a net job in over a decade. There's been a little loss, a net loss in jobs. They have substituted capital for labor but they haven't created jobs, and it's become a very serious problem in several of those countries. We have urged a change in that system. We have urged opening capital markets, and Japan was the most difficult, but progress is being made there. The Germans have reduced some of the restrictions in their capital markets. The British are fairly clean on that front. The French had many restrictions that they are now eliminating.

So we have their attention. They are listening. They appreciate it's a problem, but it's a political problem as well as an economic problem. Usually the economic analysis and solution is simple but the difficult part is the politics.

Representative HAMILTON. Mr. Chairman, I have just one other question for Dr. Sprinkel and that relates to the simple question of why the interest rates are so high. We've got an inflation rate now that is very good, as you commented on, 2.5 percent I think at an annual rate now or something like that, but the short-term interest rates are 7.5 to 8 percent and the long-term interest rates are 9.5 to 11. Why are these interest rates so high in light of this good performance on inflation?

Mr. SPRINKEL. Well, they are high, but they are well below where they were 4½ years ago. If I remember correctly, the prime was 21 maybe 21.5 percent. It's down now to 9.5 percent. Long-term rates have fallen 300 or 400 basis points. But they still appear high with respect to inflation and, in my opinion, the major reason is the probability that we have not yet fully convinced the American people that we're going to keep the inflation down where it is. Now when they commit to a mortgage or commit to loan long-term money, they have to not only be concerned about inflation today but expected inflation over the longer run.

Now we have made major progress by all the surveys that I've seen in pulling inflation expectations down, but those inflation expectations remain significantly above the actual rate of inflation and this means that we must pursue monetary and fiscal policies that will contribute to further reduction in anticipated inflation and we must continue to perform. I have not known of an administration that came to town and said they wanted higher inflation and higher interest rates, but some of them haven't performed. We want to continue to perform to keep the inflation rate down.

Representative HAMILTON. Thank you.

Senator ABDNOR. Thank you. We've been joined by Senator Symms. We're going to have to move along to our next panel, but do you have any questions?

Senator SYMMS. No, Mr. Chairman, thank you.

Senator ABDNOR. Dr. Sprinkel, we thank you for taking your valuable time to come here before us. Your testimony has been very helpful and we're looking forward to working with you as time goes by. We have had some troublesome times but maybe by the next time we meet there will be a clearer course charted out in the direction we would like to be going. We thank you for your attendance today.

Mr. SPRINKEL. Thank you very much, Senator Abdnor.

Senator ABDNOR. Now I'm going to call to the table three very distinguished economists who are going to further enlighten us on U.S. economic trends. Dr. Alan Greenspan, Dr. Lawrence Chimerine, and Dr. David Bostian.

Gentlemen, we're very pleased to have you here. I've heard four economists never agree and I don't profess to know that much about the economy, but I know that it's like predicting ballgames. Sometimes if the experts have indicators it gives them different conclusions. But we're anxious to hear from you and, Dr. Greenspan, why don't you start us off here.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I trust that despite the fact that we're inevitably going to have differing views, we hopefully will be able to clarify what the situation is.

We are currently in a period without historical precedent in the degree to which our economy and our policies are being driven by external forces. Concern over the exchange rate for the American dollar in times past was an esoteric subject of interest, and sometimes not very much interest, only to a limited number of central bankers. Now the wide swings in the dollar during the past 5 years, and especially since 1984, have been a key determinant of the structure of American economic performance. Moreover, the direction of the dollar over the next year will almost surely condition the behavior of the American economy in the period immediately ahead.

Underlying demand in the American economy over the past year has not been weak, in the sense that domestic purchases, that is the sum of consumer outlays, business expenditures on plant and equipment, homebuilding, Government outlays, and inventories, rose in constant dollars by 3.3 percent from the second quarter of 1984 to the second quarter of 1985. The net imports share of total domestic purchases, however, rose during the period from 0.7 percent during the second quarter of 1984 to an estimated 2 percent during the second quarter of this year. The flash GNP apparently estimates some decline in that ratio for the third quarter and, indeed, that is an issue I would like to return to shortly. In any event, the rise in imports share had the effect of absorbing two-fifths of the rise in domestic purchases, leaving only three-fifths for domestic production growth, that is gross national product, which grew only 2 percent for the year, second quarter 1984 to second quarter 1985.

Since most of the expansion in net imports took the form of goods rather than services, there was a disproportionate drag on industrial production growth in the United States. As a consequence, production, which grew by 10.6 percent from August 1983 to August 1984, slowed to 1.1 percent growth in the past 12 months.

Not only has the strong dollar had a significant negative impact on the growth of physical volume in the United States, but it also obviously has been a major factor in suppressing the rate of inflation through its impact on import prices, which declined on average at a 3-percent rate during 1983 and 1984. Import prices have not yet begun to reflect the dollar weakness of the last 6 months. The consequent curtailment of industrial profit margins would have led one to anticipate exceptionally weak capital investment, especially by manufacturing corporations. Despite the decline of manufacturers' capital appropriations in the second quarter, the levels remain high, and, indeed, represent a significant factor in maintaining the pace of economic activity and in forestalling a recession.

What is clear, in retrospect, is that industrial corporations, pressured by foreign competition and eroding prices, embarked upon a dual effort: First, to increase foreign sourcing, that is, putting

plants and arranging for parts manufacture abroad; second, to engage in a substantial amount of cost-saving expenditures on equipment in order to make competitive the cost structure of plants in the United States.

As a consequence, the near-term outlook is one of moderately expanding domestic purchases and probably a slowing in the rate of increase of net imports share of overall U.S. markets.

Even considering the large decline in imports in July's Bureau of the Census release, one does not know whether the judgment of little change in constant dollar net exports, or net imports depending on how you look at it, in the current quarter will survive with fuller information. But clearly, at some point the onset of dollar decline earlier this year and especially in recent days and import weaknesses will have an impact on GNP. Even if that impact has already started, it is premature to presume that it will be sufficient to soon halt import growth. Past data suggest that it is at least a year before exchange rate changes become clearly discernible in the import/export data. The full impact requires 2 years or more before all of the elements manifest themselves: changing profit margins on foreign goods, consumers shifting their pattern of buying from foreign sources back to domestic, and the adjusting of orders to be converted into deliveries. It is clear, however, at some point that: First, the rise in the share of imports will come to a halt if it has not already done so, and second, will start to head downward. Remember, however, that the exchange rate was not the sole determinant of the erosion in our net import position. A considerable amount, perhaps the entirety, of our loss of exports to Latin America resulted from the debt crisis rather than the exchange rate. Ironically, the weakness in oil prices, which indeed brought our imports down, also had a negative impact on our exports of equipment and supplies to the OPEC nations. Thus, even were the dollar to fall back to its levels of earlier in the decade, we might be unable to restore our trade position of that time.

In evaluating the broad areas of effective demand, it is clear that consumer expenditures are likely to grow at a rather subdued rate, certainly far less than in the buoyant period of 1983 and 1984. The pent-up demand of the early 1980's, which was a major factor in the extraordinary consumer boom that carried through the summer of 1984, is now pretty much spent. Consumer spending growth has been fostered during the past year by significant increases in outstanding consumer credit in the form of more lenient terms on automotive installment loans and a continuing substitution of credit card transactions for cash settlements. Realized capital gains on the sale of existing homes, financed by new mortgages, also contributed substantially to consumer purchasing power. These capital gains are no longer expanding, nor are consumer incomes, now the most important source of consumer expenditures growth.

In fact, if we are to believe the latest set of data, the consumer savings rate has slipped to a slim 3 percent or less, making it likely that expenditures growth will be limited to the growth rate of disposable personal income at most, or more probably something less, so that some upward drift in the savings rate occurs.

Growth prospects at present depend critically on a rebound in inventory investment, which has been significantly retarded in recent quarters. If one examines manufacturers' inventory/sales ratios adjusted for the effect of the business cycle, it becomes fairly apparent that the inventory weakness in recent months reflects a marked shortening of average leadtimes on deliveries of materials from suppliers. That decline, in turn, reflects the increased excess capacity of manufacturers during the past year and their consequent ability to offer shorter delivery schedules. Leadtimes, however, apparently reached rock bottom, a virtual hand-to-mouth basis, sometime this past spring and have increased since then. If the usual relationships prevail, inventory investments should start to quicken this fall. As a consequent, we would expect GNP growth to approximate 4 percent in the fourth quarter, perhaps somewhat more, and hover around the 4-percent range during the first half of 1986. The period beyond the fall of 1986, however, is exceptionally clouded by uncertainties with respect to budget deficits, remaining trade imbalances, and the rate of inventory investment reaching its peak from its current reduced levels. There is also the likelihood that the surge in nonresidential construction, to a substantial extent engendered by tax incentives, will have passed its peak and begun contracting. Moreover, the capital investment of manufacturers, now largely focused on reduction in unit costs, represents some urgency rather than a continuing process. Thus, a late 1986 downturn in manufacturing investment may naturally succeed accelerated 1985 capital outlays.

Finally, increasing corporate fixed costs relative to aggregate cash-flow, a reflection of the growing burden of debt, are likely to make the demand for funds interest insensitive. As a result, even modest increased demands by the business sector required for expansion for this year and next, may put disproportionate pressure on interest rate levels. The Federal Reserve, with its new commitment to deflate the U.S. dollar in international financial markets, thereby faces undefined upper limits for short-term interest rates. This raises the additional uncertainty of money supply expansion overrunning desirable levels, with the potential of inflationary consequences, should interest rates be artificially suppressed by the Federal Reserve.

It is certainly premature to predict a recession in the latter months of 1986 or even beyond. It is also clear, however, that a projection of continued expansion which one would normally make, given still subnormal levels of inventories, as distinct from the rate of change, is inappropriate at this stage.

Thank you very much.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN*

We are currently in a period without historical precedent in the degree to which our economy and our policies are being driven by external forces. Concern over the exchange rate for the American dollar in times past was an esoteric subject of interest, and sometimes not very much interest, only to a limited number of central bankers. Now the wide swings in the dollar during the past five years, and especially since 1984, have been a key determinant of the structure of American economic performance. Moreover, the direction of the dollar over the next year will almost surely condition the behavior of the American economy in the period immediately ahead.

Underlying demand in the American economy over the past year has not been weak, in the sense that domestic purchases, that is the sum of consumer outlays, business expenditures on plant and equipment, homebuilding, government outlays, and inventories, rose in constant dollars by 3.3% from the second quarter of 1984 to the second quarter of 1985. The net imports share of total domestic purchases, however, rose during the period from 0.7% during the second quarter of 1984 to an estimated 2.0% during the second quarter of this year. The flash GNP apparently estimates some decline in that ratio for the third quarter and, indeed, that is an issue I would like to return to shortly. In any event, the rise in imports share had the effect of absorbing two-fifths of the rise in domestic purchases, leaving only three-fifths for domestic production growth, that is gross national product, which grew only 2.0% for the year, second quarter 1984 to second quarter 1985.

Since most of the expansion in net imports took the form of goods rather than services, there was a disproportionate drag on industrial production growth in the United States. As a consequence, production, which grew by 10.6% from August 1983 to August 1984, slowed to 1.1% growth in the past twelve months.

Not only has the strong dollar had a significant negative impact on the growth of physical volume in the United States, but it also obviously has been a major factor in suppressing the rate of inflation through its impact on import prices, which declined on average

*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

at a 3% rate during 1983 and 1984. Import prices have not yet begun to reflect the dollar weakness of the last six months. The consequent curtailment of industrial profit margins would have led one to anticipate exceptionally weak capital investment, especially by manufacturing corporations. Despite the decline of manufacturers' capital appropriations in the second quarter, the levels remain high, and, indeed, represent a significant factor in maintaining the pace of economic activity and in forestalling a recession.

What is clear, in retrospect, is that industrial companies, pressured by foreign competition and eroding prices, embarked upon a dual effort: (1) to increase foreign sourcing, that is, putting plants and arranging for parts manufacture abroad; (2) to engage in a substantial amount of cost-saving expenditures on equipment in order to make competitive the cost structure of plants in the United States.

As a consequence the near-term outlook is one of moderately expanding domestic purchases and probably a slowing in the rate of increase of net imports share of overall U.S. markets.

I mentioned earlier the flash report of GNP, an artistic construction of the Department of Commerce, considering that we probably have available only half the data required for an estimate. Moreover, considering the large decline in imports in July's Bureau of Census release, one does not know whether the judgment of little change in constant dollar net exports in the third quarter will survive with fuller information. But clearly, at some point the onset of dollar decline earlier this year and import weaknesses will have an impact on GNP. Even if that impact has already started, it is premature to presume that it will be sufficient to halt import growth. Past data suggest that it is at least a year before exchange rate changes become discernible in the import/export data. The full impact requires two years or more before all of the elements manifest themselves: changing profit margins on foreign goods, consumers shifting their pattern of buying from foreign sources back to domestic, and the adjusting of orders to be converted into deliveries. It is clear, however, at some point that: (1) the rise in the share of imports will come to a halt if it has not already done so and (2) will start to head downward. Remember, however, that the exchange rate was not the sole determinant of the erosion in our net import position. A considerable amount, perhaps the entirety, of our loss of exports to Latin America resulted from the debt crisis rather than the exchange rate. Ironically the weakness in oil prices, which indeed brought our imports down, also had a negative impact on our exports of equipment and supplies to the OPEC nations. Thus, even were the dollar to fall back to its levels of earlier in the decade, we might be unable to restore our trade position of that time.

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Growth prospects at present depend critically on a rebound in inventory investment, which has been significantly retarded in recent quarters. If one examines manufacturers' inventory/sales ratios adjusted for the effect of the business cycle, it becomes fairly apparent that the inventory weakness in recent months reflects a marked shortening of average lead times on deliveries of materials from suppliers. That decline, in turn, reflects the increased excess capacity of manufacturers during the past year and their consequent ability to offer shorter delivery schedules. Lead times, however, apparently reached rock bottom, a virtual hand-to-mouth basis, sometime this past spring and have increased since then. If the usual relationships prevail, inventory investments should start to quicken this fall. As a consequence, we would expect GNP growth to approximate 4% in the fourth quarter, perhaps somewhat more, and hover around the 4% range during the first half of 1986. The period beyond the fall of 1986, however, is exceptionally clouded by uncertainties with respect to budget deficits, remaining trade imbalances, and the rate of inventory investment reaching its peak from its current reduced levels. There is also the likelihood that the surge in nonresidential construction, to a substantial extent engendered by tax incentives, will have passed its peak and begun contracting. Moreover, the capital investment of manufacturers, now largely focused on reduction in unit costs, represents some urgency rather than a continuing process. Thus, a late 1986 downturn in manufacturing investment may naturally succeed accelerated 1985 capital outlays.

Finally, increasing corporate fixed costs relative to aggregate cash flow, a reflection of the growing burden of debt, are likely to make the demand for funds interest insensitive. As a result, even modest increased demands by the business sector required for expansion for this year and next, may put disproportionate pressure on interest rate levels. The Federal Reserve, with its new commitment to deflate the U.S. dollar in international financial markets, thereby faces undefined upper limits for short-term interest rates. This raises the additional uncertainty of money supply expansion overrunning desirable levels, with the potential of inflationary consequences.

It is certainly premature to predict a recession in the latter months of 1986 or even beyond. It is also clear, however, that a projection of continued expansion which one would normally make, given normal levels of inventories, is inappropriate at this stage.

Senator ABDNOR. Thank you, Dr. Greenspan.

Our next panelist is Dr. Chimerine. We're pleased to have you here, Dr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. CHIMERINE. Thank you, Mr. Chairman. I have submitted a prepared statement which I ask be inserted in the record.

Senator ABDNOR. Your entire prepared statement will be made a part of the record.

Mr. CHIMERINE. What I would like to do now, Mr. Chairman, is to fairly briefly summarize that prepared statement and do so in a way that doesn't repeat some of the observations that Alan Greenspan just made. I'd like to focus essentially on three issues related to the outlook.

First, to review where we've been over the past year or so; second, to assess what the situation is right now; and third, to discuss the key forces that will affect the economy over the next year or so, without worrying too much about the precise numbers, or particular quarters, but focusing on underlying growth prospects.

I think the first point to make, as Alan Greenspan noted earlier, is that there's been a marked change in the recovery process from the earlier stages of the recovery. During the last 12 or 13 months, the rate of recovery has dropped off very sharply. In fact, growth has been well below the long-term average in the United States as measured by GNP. GNP growth in real terms has been only about 2 percent during the four quarters prior to the current on. Before we look ahead, it's essential to look at the forces that produced this dramatic change in the recovery process.

I think there are three main factors, or really two factors and one category of factors. The latter one I'm referring to is a group of temporary forces which helped propel the economy forward during the early part of the recovery, one which may have led some people to be overly exuberant about longer term growth prospects and extrapolate that early rapid growth. However, some of these temporary stimulants were bound to fizzle out even under the best of circumstances; as a result, the rate of growth in the economy was likely to slow down dramatically as it has during the last 12 months.

The factors I'm referring to include the need that many industries had to rebuild inventories in 1983 and early 1984 because they had been cut so dramatically during the previous recession. Accelerated depreciation and the other investment incentives that were enacted in 1981 temporarily stimulated the growth in investment until companies reached a higher capital stock, but once that was realized, the growth in investment has gone back to its previous rates.

The Fed was very accommodative during much of 1982 and most of 1983. They were not likely to continue that degree of accommodation. A lot of the pent-up demand that Alan Greenspan referred to earlier was already used up by mid-1984.

So for these and other reasons, it was probably misguided to extrapolate the kind of growth we had in 1983 and early 1984. A sharp slowdown was clearly likely.

What surprised many people is the extent of that slowdown, and I think that results from the other two factors.

One of them is high-real interest rates, which have limited the growth in demand to some extent for certain type of the decisions that are made in the economy. The traditional way many of us measure real interest rates is to use the CPI, the GNP deflator as the inflation measure, but I don't think that's relevant for a company in the industrial sector who's considering how much inventory to build, or is considering whether to build a new factory or buy a new piece of equipment. What matters for him is what happens to the prices of the goods he holds in inventory, or prices of the goods he's going to produce.

Companies in the industrial sector have not been able to raise prices for a long period of time, nor can they assume that they will be able to raise prices at any time in the near future. So for practical purposes, their inflationary expectations have been zero. Today's interest rates, even with recent declines, are extremely high relative to zero inflation, and have caused many companies to scale back their inventories. We've gotten some rebuilding, but not as much as we would typically get during a recovery. High-rate interest rates are also impacting some capital spending decisions, particularly since for many companies, the highest rate of return projects and the most necessary expenditures were already made earlier in the recovery.

At this point in the recovery process—during the last year or so—high real interest rates have thus had a bigger bite than they did earlier.

Another example is the housing industry—12 percent mortgage rates relative to 3 or 4 percent income growth still represents a relatively high financing load for many families. Once the most needy buyers have already funded a new house, the ones that remain obviously to some extent are thus priced out of the market at today's real mortgage rates.

Then comes the third factor and Alan talked extensively about that, namely the dollar. You all are aware of the enormous import penetration that is spreading throughout the United States. In addition, over the last 7 or 8 months, exports have come down again from a relatively low level. And profit margins are being squeezed. All of these effects have begun to have a very negative impact on economic performance, especially since domestic demand is not growing as rapidly as it did a year or two ago. There just isn't enough room for the economy to handle both increased domestic production and increased import penetration simultaneously at this stage in the recovery process.

So these are the factors that produced the slowdown. I think the second question becomes, especially in view of some very optimistic forecasts, is whether a major consideration or boom is ahead. First, I'd like to say that we see no evidence of that at the moment.

Some of the recent statistics clearly display more strength in the economy, but I would urge everybody not to rely too heavily on the monthly economic data. I would remind you that a month ago,

after the weak July statistics, there were a number of people talking about a recession. The monthly data have become notoriously unreliable and, in particular, the recent statistics, such as auto sales, as the July trade deficit, and a few others, have been heavily impacted by relatively temporary forces so they clearly overstate the current strength in the economy. Recent auto sales levels are not going to be sustained because those low interest rate promotions are, if anything, borrowing sales from the future, and the declining trade deficit in July was heavily the result of temporary declines in imports of oil, oil products, and automobiles.

As far as we can determine, only a modest acceleration in economic activity is now underway. It is very modest, somewhere in the 2.5-percent growth range. In fact, it is probably consistent with the flash report estimate, although for the wrong reasons since the flash report estimate probably doesn't really reflect what's going on in the economy. Nonetheless, I think the best we can say at the moment, when you cut through the economic statistics and factor in the anecdotal evidence we get from our clients, at best only a modest acceleration in economic activity is currently underway.

Will it pick up and, importantly, will it pick up on a sustained basis? Really, I'm asking the question, can we get sustained growth in the 5-percent range that the administration is counting on, and that some others have been forecasting? In my judgment, the answer is no, for a number of reasons.

Many who take that view are basing it on the assumption that the Fed has been highly stimulative during the last 9 or 10 months as evidenced by the double digit rate of growth in the basic money supply. Their view is based on historical relationships which suggest that growth in the money supply is soon going to cause a major acceleration in economic activity in the United States. I don't believe so.

First, the growth in M1 overstates the degree of easing to some extent for a number of reasons, particularly a shifting of deposits out of some of the thrifts caused by the problems that some of the thrifts are having, and shifts of other deposits into interest-bearing checking accounts at commercial banks. In many cases, these are just savings being shifted from other types of savings accounts rather than the traditional transaction balances that would normally be included in M1.

So, since financial market deregulation, M1 is not a meaningful measure of expected economic performance. M1 is also being distorted by import penetration in the United States because the demand for credit and the growth in money to finance the purchase of a Toyota is almost the same as it is to finance the purchase of a domestically produced car, yet the former does not have any significant impact on domestic economic activity. So, as long as we have growing import penetration, the relationship between the money supply and economic activity which by the way I don't think was ever all that close, will be further distorted.

Second, real interest rates remain extremely high, as I discussed earlier, and is still having somewhat of a restrictive effect on economic activity despite the strong growth in the basic money supply.

Third, the money supply is not the only factor that affects the economy. There are other factors. I would be the first to admit that

if the Fed hadn't begun easing 9 or 10 months ago, the economy would probably be in a recession right now because most of the other underlying fundamentals are not favorable for growth. And while the easier Fed policy is offsetting some of them, in my judgment, this won't be sufficient to produce a sustained strong economic boom.

What are some of these other factors? Well, first, as Alan Greenspan mentioned, vacancy rates throughout construction are very high. Apartment buildings, condominiums, commercial structures, low occupancy rates in hotels—all of the construction boom is now beginning to fizzle out as a result of these extremely high vacancy rates.

Second, industrial capacity is highly excessive. In fact, it's hard to find another economic recovery in our history during which the third year was characterized by falling utilization rates and utilization rates which are as low as they are right now. As a result, industrial construction, which never really recovered from the 1981–82 recession in the first place is now weakening further.

So at least the construction part of plant and equipment spending is likely to weaken, as will multifamily housing construction.

Third, the financial condition of households in the United States is not favorable. Debt burdens have risen significantly. Real income growth is very slow, primarily because of wage cutbacks and because of the shifting of workers away from high wage industries, particularly in manufacturing, to low wage industries. In addition, the saving rate is currently at an all-time low level, and while that hardly reflects the weakness in farm and interest income which have only very small effects on spending in the short term, it also to some extent reflects the fact, in my judgment, that consumption spending has not yet fully adjusted to the slowdown in income growth we've experienced during the last year.

In effect, what's happening is that as we spend more on imports, we're not creating income in the United States. Eventually, that process cannot continue—the lack of income will force cut backs in spending. I don't think we have seen that full impact at this point.

So, in my judgment, the household sector is certainly not in a position to stimulate strong economic growth.

Furthermore, while I don't think we'll see too much more inventory liquidation, I doubt very much whether inventories will be a source of economic strength. If the economy does pick up, companies will then rebuild inventories to maintain their inventory sales ratios, but a rebuilding of inventories on a large scale will not lead the economy forward. Neither will rising capital spending, particularly in view of weak profits and lower utilization rates and the other factors I've talked about.

When you put it all together, Mr. Chairman, in my judgment, we could get one or two quarters of faster growth, and that would be reminiscent of the fourth quarter of 1984, which did pick up and led to expectation of a resumption of strong growth. But the underlying fundamentals suggest that strong growth cannot sustained, especially since even modest economic growth is likely to be accompanied by a pickup in interest rates in view of very poor outlook for the Federal deficit. That would be another factor which is likely

to prevent us from sustained strong economic growth during the period ahead.

In my judgment, therefore, between now and the end of 1986, the best we can hope for is average economic growth somewhere in the 2.5-percent range. And, in my view, most of the risks are on the down side.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

Prepared Statement of Lawrence Chimerine

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Subcomittee on Trade, Productivity, and Economic Growth of the Joint Economic Committee on the "Economic Outlook Through 1986."

Summary

In sum, my views are as follows:

(1) The U.S. economy has experienced relatively slow and erratic growth since the early summer months of 1984. This represents a sharp slowdown from the pattern during the first year and a half of the recovery.

(2) Several recent statistics which appear to suggest that a sharp acceleration in economic growth is now underway, overstate the strength in the economy--at best, only a modest pickup in economic growth is now taking place.

(3) Strong growth in the money supply during the last ten months has also generated hopes for a new economic boom. However, the growth in the basic money supply (M1) overstates the degree of stimulus because it partially reflects changes which have resulted from financial market deregulation and other factors, rather than increases in transaction balances. In addition, real interest rates remain extremely high, particularly for industrial companies and for prospective home buyers. Finally, the U.S. dollar has lagged behind the decline in nominal interest rates and remains highly overvalued on foreign exchange markets--this will prevent any significant improvement in the trade deficit in the near future.

(4) Underlying factors suggest that, while a recession is not likely between now and the end of 1986, sustained very strong growth is equally unlikely. These include continued relatively high real interest rates, the still highly overvalued U.S. dollar, slow growth in household income and an extremely low saving rate, weak profits, and high and rising excess capacity in the industrial sector and most segments of construction. On the other hand, declining oil prices and generally low inflation, the absence of a substantial inventory overhang, rising military expenditures, and increases in cash flow resulting from rising depreciation allowances, will bolster economic activity. The net impact will be slow growth on average.

(5) The continued bleak outlook for the Federal deficit will also limit economic growth during the period ahead, since interest rates and a rising dollar will likely accompany any meaningful pickup in the economy until the deficit is reduced. Such increases in rates and the dollar will only slow the recovery process again shortly thereafter.

Recent Economic Performance

After the extremely strong growth experienced during the first six quarters of the current recovery, the nature of the recovery process has changed dramatically. In fact, during the last four quarters economic growth has averaged only 2%, not only far below the rate of growth earlier, but even well below long-term average growth in the United States. This slowdown occurred just when many were predicting that a continuing economic boom was in store, fueled by the tax cuts that were enacted in 1981. At the outset, it should be recognized that there was no economic boom in the first place. The problem stems from confusion between the direction and the level of economic activity--while the economy was moving upward at a very rapid rate during the first half of 1984, economic activity was still considerably below its potential, reflecting the extremely weak conditions from which the recovery began. Thus, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory at that time, and in most cases, had not even returned to the relatively sluggish levels which existed in the 1970s. In fact, many industries and geographic areas were still extremely depressed, having experienced virtually no recovery at all.

Two other important aspects of the earlier stages of the economic recovery are also essential to help understand why rapid growth has been so short-lived. First, the recovery was not caused by tax cuts alone; to a significant degree, what was in place was a cyclical rebound caused by a number of relatively transitory factors, such as inventory rebuilding in many industries, the large amount of pent-up demand for consumer durables and other goods that had previously built up, and an extremely loose monetary policy. The stimulative impact of these factors, as well as of the tax cuts and rising budget deficits, was bound to diminish in magnitude. Second, the faster-than-expected recovery during 1983 and early 1984 was simply using up idle resources more rapidly than had been anticipated, rather than reflecting any major improvement in the long-term growth potential of the U.S. economy.

So for all of these reasons, the rosy extrapolations regarding future growth were premature and dangerous to begin with--the fact that economic growth has moderated thus comes as no surprise. What is highly disturbing, however, is the degree to which the pace of economic expansion has slowed. Growth over the last year has not only lagged far behind the "New Era" expectations, but as mentioned earlier, it has even been considerably below the long-term average of the U.S. economy, even though the recovery is far from complete. Why? In my view, in addition to the fading out of the temporary growth stimulants mentioned earlier, the slowdown in economic growth is also being caused by the enormous and growing Federal budget deficit which has in large part resulted from those massive tax cuts enacted in 1981.

How could the same factor actually help speed the recovery at one time and, at another, act to slow it down? In 1983 and much of 1984, when private borrowing was relatively low, when the Federal Reserve was highly accommodative, and when a large fraction of the Federal deficit actually reflected the low level of economic activity (i.e., was cyclical in nature), large and growing deficits stimulated demand and thus helped propel the economy forward. More recently, however, these underlying conditions have changed--private borrowing has increased rapidly in tandem with the recovery thus far; the Federal Reserve is not permitting the growth in money and credit on a continuing basis at the relatively high rates experienced earlier in the recovery; and most importantly, the rising deficit now primarily reflects a growing structural imbalance between revenues and expenditures rather than cyclical factors. These growing deficits are keeping interest rates well above historical levels, which is primarily responsible for the increase in net foreign demand for U.S. assets which has caused the U.S. dollar to become so overvalued on foreign exchange markets. In effect, interest rates and the U.S. dollar are too high to permit more rapid economic growth and are thus the two principal factors preventing a faster completion of the recovery process--in turn, both are primarily caused by high and rising Federal budget deficits at a point in the recovery when they should be falling sharply. Federal deficits have thus become counterproductive for economic growth--the direct stimulus of such deficits is now being outweighed by the adverse effects of the excessively high interest and dollar exchange rates which they have caused.

Interest rates are especially high when measured relative to the inflation rate for goods (which strongly influences capital spending and inventory decisions) and relative to wage growth (which affects the demand for housing). These real interest rates have remained extremely high, despite an accommodative monetary policy (especially during the last several months), and despite the massive inflow of foreign capital from overseas and cutbacks in foreign lending by

U.S. banks, because of the enormous amount of Treasury borrowing. This is compounded by the economy's increased sensitivity to high rates because many of the most necessary and highest-return expenditures and investments were made earlier in the recovery--in more and more cases, those now being considered are not economical at current interest rates.

The situation with respect to the U.S. dollar is similar--although it has weakened some in recent months, it remains at least 30% overvalued on a purchasing power parity basis. The overly strong dollar exchange rate is now restraining economic activity in the United States in several ways: (a) It has been a major factor behind the very sharp and widespread increases in import penetration, and very soft exports, which are causing enormous U.S. trade deficits despite falling oil imports. Until now, most of the growth in imports has come from foreign-based corporations--however, more U.S. companies are now beginning to shift production overseas, suggesting that substantial increases in imports from foreign operations of U.S. based companies, and more sluggish U.S. exports, are likely. Furthermore, import prices were not reduced when the dollar continued to strengthen in late 1984 and early 1985--profits earned in U.S. markets by foreign companies just widened further. Thus, the recent decline in the dollar will probably not result in higher prices for imported goods, and therefore is probably not sufficient to significantly improve the competitive position of U.S. companies in world markets. Therefore, unless the dollar drops far more sharply, the trade deficit will become even larger in the months ahead. (b) As evidenced by recent earnings reports, the strong dollar is causing a profit squeeze by preventing most industrial companies from raising prices; this in turn is reducing the growth in capital spending. (c) Many companies are increasing their efforts to cut wages in order to at least partially offset declining profits--this, combined with the direct job loss in the relatively high-wage manufacturing sector, has caused a sharp deceleration in the growth in personal incomes, and thus slower growth in consumer spending. Furthermore, the benefits of relatively low inflation caused by the strong dollar are less than is commonly assumed, since they are largely offset by the squeeze on profits and/or cutbacks in wages--this source of disinflation does not stimulate economic activity to the same extent as does lower inflation caused by rising productivity.

Several industries have already been devastated by the high interest rate/overvalued dollar combination. In fact, while the woes of the agricultural sector have been heavily publicized, what has been less noticed is that the industrial sector, which accounts for about 30% of total economic activity in the United States, has stagnated since mid-1984. Furthermore, the squeeze is now beginning to spread. Even high-tech industries are experiencing a significant

loss of orders due to the direct and indirect effects of high interest rates and the overvalued dollar. And parts of the service sector, which previously had been relatively strong, are beginning to be adversely effected. This is true both for various business services, as demand from manufacturing companies falls, and for some household services, as the job and income loss associated with declining manufacturing and other interest and exchange rate sensitive industries increases. This will dispel the myth that the U.S. economy can continue to grow at healthy rates when a sizable fraction of it is not growing, or is actually declining--in fact, exactly the opposite is the case.

Current Economic Conditions

Several recently released statistics are being cited as evidence that a major acceleration in economic activity may have already begun. However, such a conclusion is not warranted; more likely, sustained strong growth will not be realized during the remainder of this year and 1986, with only a very modest acceleration the best that can be hoped for. These recent data include the following:

1. Auto Sales: Auto sales surged to near record levels during late August and early September, reflecting two major factors. First, low-cost financing is now being offered by the major domestic manufacturers--on average, more than $1,000 can be saved over the life of a typical auto loan. Second, the end of the car haulers' strike permitted many cars which had been previously ordered to be delivered (the auto sales statistics measure deliveries, not new orders) in recent weeks. Both of these factors are temporary, however; in fact, as much as 75% of increases in auto sales resulting from promotional programs in the past have been borrowed from future periods. Thus, recent sales are not indicative of a new uptrend in auto sales. And, the increase in auto sales will not likely increase third-quarter GNP, since it will result in a faster reduction of inventories of 1985 models rather than higher production.

2. Chain Store Sales: Most of the major chain stores have reported somewhat greater year-to-year sales increases for August than in previous months. However, sales in August of 1984 were not overly strong. Also, Labor Day and the start of the school year came very early this year, which may have shifted some school-related purchases from September into late August. Thus, the only moderate growth pattern in retail activity that has been in place seems still intact.

3. Retail Sales: Retail sales rose a relatively strong 1.9% in August. However, it was heavily impacted by the factors discussed above. First, most of the rise was the result of a sharp increase in auto sales in late August--nonauto sales rose by a very modest 0.4%. Second, sales in the nonauto sector were probably buoyed by the early Labor Day. Finally, retail sales for July, which were already sluggish, was revised further down ward. Thus, the August data do not indicate any basic uptrend in retail activity.

4. Unemployment: The unemployment rate fell by a surprising 0.3 percentage points in August. However, while the increase in employment (as measured by both the household and payroll surveys) was reasonably good, the absence of any growth in the labor force accounted for a significant part of the reduction in the unemployment rate. The labor force has in fact been relatively flat all year, which helps explain why unemployment has not trended upward despite the sluggish economy. The largest decline in unemployment in August was among teenagers, which may reflect typical seasonal adjustment problems at this time of the year. Thus, I expect unemployment to bounce back up in coming months.

5. Leading Indicators: The index of leading indicators rose 0.4% in July. However, the increase in the previous month was revised down sharply. Furthermore, about 75% of the July increase was in the money supply and the stock market, rather than in indicators more directly reflective of the health of the "real" economy. Finally, periods of rapid growth have historically been preceded by much stronger increases in the index than those experienced in recent months.

6. Trade Deficit: The trade deficit in July was about $2.5 billion less than in June--however, most of the difference resulted from temporary declines in imports of oil and foreign cars which are not likely to be sustained. Furthermore, exports weakened again in July, continuing the pattern of recent months. Thus, the trade deficit will likely resume its upward trend during the next several months.

7. Housing Starts: Housing starts rose to its highest level in many months during August; however, while some improvement in housing activity is likely in view of recent declines in mortgage rates, almost all of the August increase was in multifamily construction. This surge in apartment and condominium construction reflects anticipation of tax reform, which would curtail many of the benefits associated with such construction, as well as an expected cutback in industrial revenue bond financing. In view of high vacancy rates throughout much of the United States, August multifamily construction activity seems unsustainable.

Thus, these data do not provide conclusive evidence that a major acceleration in economic growth is already underway. What is occuring is a modest pickup in economic activity that appears to be in line with the third-quarter flash report for real GNP--that is, when all of the statistics are sorted out, the economy is currently growing at a rate of about 2.5%. While this is significantly better than the growth rate during the first half of this year, it is still not sufficient to help alleviate some of the economic problems which we are now experiencing.

Fiscal Policy Outlook

Congressional budget projections incorporating the recently adopted budget resolution indicate that the deficit will decline to about $130 billion per year by the end of the decade from the FY 1985 estimate of $210 billion, instead of rising to nearly $275 billion under previous law. However, spending reductions will fall short of the targets in the budget resolution and the economy will be far weaker than Congressional estimates. Thus, the deficit will remain near $200 billion per year, barring any new actions. This is not sufficient to eliminate the substantial pressure on interest rates and the U.S. dollar that has been caused by large structural budget deficits. The still poor deficit outlook reflects:

1. National defense accounts for almost half of the total spending reductions in the budget resolution for the next three years. However, actual spending may exceed the budget resolution targets, since it is unlikely that: (a) any of the major weapons systems will be scaled back sharply--in fact, the recent shortfall in military expenditures is in part the result of delays in orders and deliveries of various weapons systems, rather than actual cutbacks; (b) any more military bases will be eliminated because of local Congressional resistance; and (c) operations and maintenance expenditures can be scaled back further.

2. Reconciliation instructions for a large portion of the nondefense cuts were also not included in the budget resolution--it is thus up to the various appropriations committees to find ways to produce the savings. However, it is very likely that some of these cuts will not materialize in the appropriations process, because the programs involved have large constituencies in the Congress--this is especially true for farm and education programs.

3. The economic assumptions underlying the budget resolution are extremely optimistic--they are in fact the same assumptions that the Administration used as part of its budget last

February. The shortfall in economic growth during the remainder of the current year alone will increase future deficits by nearly $20 billion a year, only a small portion of which will be offset by lower-than-expected interest rates.

4. The estimated savings from some of the program changes included in the resolution appear to be somewhat on the high side.

Monetary Policy — Is the Fed pushing on a string?

There is almost universal agreement that the Federal Reserve has pursued a much more accommodative posture since late 1984—this is best indicated by the very sharp increase in the growth of nonborrowed reserves, as well as the relatively strong increase in the monetary base, since that time. Growth in the basic money supply has also been quite rapid--in fact, the 12% annual rate of increase in M1 since last September represents one of the longest periods of double-digit money supply growth in the entire postwar period. Despite this easing in monetary policy, however, the economy has grown very slowly, with only a modest pickup in economic growth now taking place. In my view, this reflects the likelihood that the stimulative impact of the recent strong growth in M1 is being overstated, for the following reasons.

1. Although interest rates have come down sharply, they remain extremely high in real terms. Thus, real short-term interest rates to finance inventories, real long-term rates to finance capital expenditures, and real mortgage rates to finance new home construction, are all still far above historical levels. Furthermore, real interest rates are now having a more restrictive effect than earlier in the recovery cycle, since a substantial portion of the pent-up demand for housing, durable goods and some types of business equipment that was created during earlier recessions has already been filled.

2. Although M1 has grown at a 12% annual rate over the last 10 months, the growth in M2 and M3 has been significantly lower. It is likely that the growth in M1 has in part resulted from a shift into interest-bearing checking deposits from other instruments--this shift has been caused by the downward trend in interest rates because of the reduced opportunity costs associated with these deposit forms. Recent difficulties among several non-Federally insured thrift institutions may also be causing some shifting of funds from thrift accounts to checkable deposits at large commercial banks, and thus into M1. In this context, it should be noted that

the other checkable deposits component of M1 has accounted for much of the growth in M1 during the last ten months. Thus, M1 may include a higher component of "savings" relative to transaction balances than has been the case in the past. The relationship between M1 and domestic economic performance has also been weakened by financial market deregulation and by the rapid growth in imports in recent years. As a result of these factors, M1 growth currently exaggerates the degree of monetary ease somewhat.

3. The effect of the Fed's easing is being significantly offset by a number of factors, most of which are highly unusual at this stage of the recovery: (a) Capacity utilization in manufacturing is both falling and relatively low--operating rates have traditionally been over 85% (and rising) during the third year of economic recoveries. Rising excess capacity is preventing more buoyant capital spending by reducing the expected return on many projects, offsetting the impact of declining rates. (b) Vacancy rates among multifamily residences, office buildings, and commercial structures are also relatively high and rising--this is already beginning to depress new construction, even with lower interest rates. (c) The recent decline in the value of the U.S. dollar on foreign exchange markets has raised hopes of an early turnaround in the U.S. trade deficit. However, I believe such an expectation is premature--my work suggests that the trade deficit will widen during the remainder of 1985 and early 1986 in response to the strengthening of the dollar which occurred during 1984 and early 1985. In addition, the trade deficit during the months ahead will be aggravated by: rising imports of autos in response to the elimination of voluntary quotas on Japanese cars, some increases in oil imports now that refined product inventories have been reduced sharply, continued relatively slow growth outside the United States, and the continuing shifting of production by many U.S. companies to their foreign operations. Furthermore, the recent decline in the dollar has not yet significantly affected the prices of most imported goods--its main effect thus far has been to reduce the extremely high profit margins associated with sales of foreign products in U.S. markets. Thus, a much larger decline in the dollar is necessary for any major turnaround in the U.S. trade deficit even after the next several quarters. (d) Inventory liquidation, such as has been occurring in recent months, is also unusual at this point in the recovery. In fact, the third year of recoveries has historically been characterized by large inventory accumulation, which has frequently sown the seeds of the next recession. Current inventory policies reflect concern regarding future sales, as well as the still high cost of financing inventories in relation to stable or declining prices for industrial commodities and finished goods. I thus expect that, even after the current liquidation process is over, strong inventory rebuilding that is consistent with rapid economic growth will not occur. (e) The loss of high-paying manufacturing jobs, and the scaling back of

wage increases throughout the economy in response to weak profits, have caused a dramatic deceleration in income growth--this again is highly unusual at this stage of the recovery. This slowdown in income growth is especially troublesome because household debt has increased significantly during the last year and because the saving rate is relatively low. The saving rate in recent months has actually been near all-time low levels--while this in part reflects the weakness in interest and farm income, much of which reduces savings rather than consumption, it also reflects the likelihood that consumer spending has not yet fully adjusted to the loss of income associated with rising imports. In effect, increased spending by consumers for imported goods does not generate equivalent income, as is the case for spending on domestically produced goods--eventually, this income shortfall will limit future spending increases. This combination will offset some of the stimulative effects of recent declines in interest rates on consumer spending, and will thus limit the growth in such spending during the period ahead. (f) While declining mortgage rates do stimulate single-family home construction (each 1% decline in mortgage rates will increase single-family starts by 125,000), the slowdown in employment and income growth represents a major offset. Furthermore, minimum downpayment and income standards for the issuance of new mortgages are being tightened as a result of newly implemented FNMA policies. This will further limit the only modest pickup in housing that had previously been expected.

In my view, the factors described above will continue during the period ahead, so that economic growth will continue to lag far behind the growth in M1.

Is the capital spending boom over?

After surging earlier in the recovery, business investment has lost considerable steam, reflecting the following: (a) The surge in capital spending in 1983 and early 1984 came from an extremely low base, and thus in part was simply a makeup for extremely depressed spending during the prior several years. (b) The stimulative effect on the desired level of capital stock of investment incentives enacted in 1981 has in large part already been realized--therefore, they will not continue to contribute to the growth in capital spending. (c) Capacity utilization is falling in many industries as a result of weak demand and/or increased outsourcing. (d) The sharp decline in profits in the last several quarters has dramatically slowed cash flow. The slowdown in capital spending is highly evident from the recent pattern of nondefense capital goods orders (which have been on a downward trend since last summer), from recent plant and

equipment surveys (which project little growth during the course of 1985 despite a significant year-over-year gain), from recent cutbacks in plant construction, and from signs that the commercial and office building construction boom of recent years is now beginning to taper off. It is thus clear that capital spending is not in a position to lead an acceleration in economic activity in the period ahead--its outlook depends heavily on the general economic and profits outlook.

Summary of the Outlook

In my view, a number of factors will combine to prevent a recession from occurring during the remainder of this year and 1986. These include the following (some of which were discussed earlier):

1. While the Fed's easing will not produce an economic boom (for the reasons already cited), it has been sufficient to prevent the economy from worsening. In particular, the increased liquidity which has resulted from the Fed's policy shift has thus far primarily bolstered the demand for stocks and bonds (as well as imported goods)--eventually, however, the increase in wealth created by higher prices of financial assets will be a modest stimulus to the demand for domestic goods.

2. Commodity prices remain very weak, despite the recent decline in the value of the U.S. dollar--while this in part reflects still weak demand, it is primarily the result of enormous supplies and overcapacity. Relatively low inflation is permitting some growth in purchasing power despite the slowdown in income growth. Furthermore, a large part of the slowdown in personal income growth is the result of declining interest income in response to lower interest rates--this is reducing savings to a greater extent than spending, as mentioned earlier.

3. Even with cutbacks, defense spending will continue to grow as previous appropriations are spent.

4. Despite the profit squeeze, cash flow continues to hold up relatively well because of increasing depreciation allowances--this will prevent capital spending from falling sharply.

5. Inventories are not now excessive in most sectors.

However, it is equally unlikely that rapid economic growth on a sustained basis can occur during the remainder of 1985 and 1986, for the reasons discussed earlier. To review, these include the following:

1. The likelihood that both interest rates and the dollar will increase somewhat in response to even a modest acceleration in economic growth in view of the still poor outlook for the Federal deficit. This will occur because rising credit demands from the private sector will be necessary to finance a significant portion of any increase in demand associated with faster growth--this is especially true in view of slow income growth and the low savings rate of households, and in view of the weakness in profits which is slowing the growth in cash flow in the corporate sector. Furthermore, much of the improvement in the economy will be housing-related, which is highly dependent on borrowed capital. These increases in credit demands, following very slow growth in such demands so far this year, will add to still high Treasury borrowing at a time when the Federal Reserve may be unwilling to continue to increase reserves at the rate at which they have grown since late last year. Any increase in interest rates and/or the dollar at this stage of the recovery, especially in view of the economy's increased sensitivity now in comparison with earlier stages of the recovery, would slow economic growth shortly thereafter.

2. Any significant improvement in the trade deficit is not likely during the forecast period. This reflects the fact that a much larger decline in the dollar will be necessary to affect import prices relative to those of goods produced in the United States (especially since any small declines in the dollar will simply be absorbed in foreign profit margins); the long lags between changes in exchange rates and their effects on imports and exports; and the continued shifting of production by many U.S. companies to their foreign operations.

3. For reasons already discussed, the outlook is for only modest growth in consumer spending at best. In fact, declines in auto sales later this year will actually cause total household spending to decline during that period.

4. Companies remain cautious about rebuilding inventories, so that inventory investment will not likely lead an acceleration in economic growth.

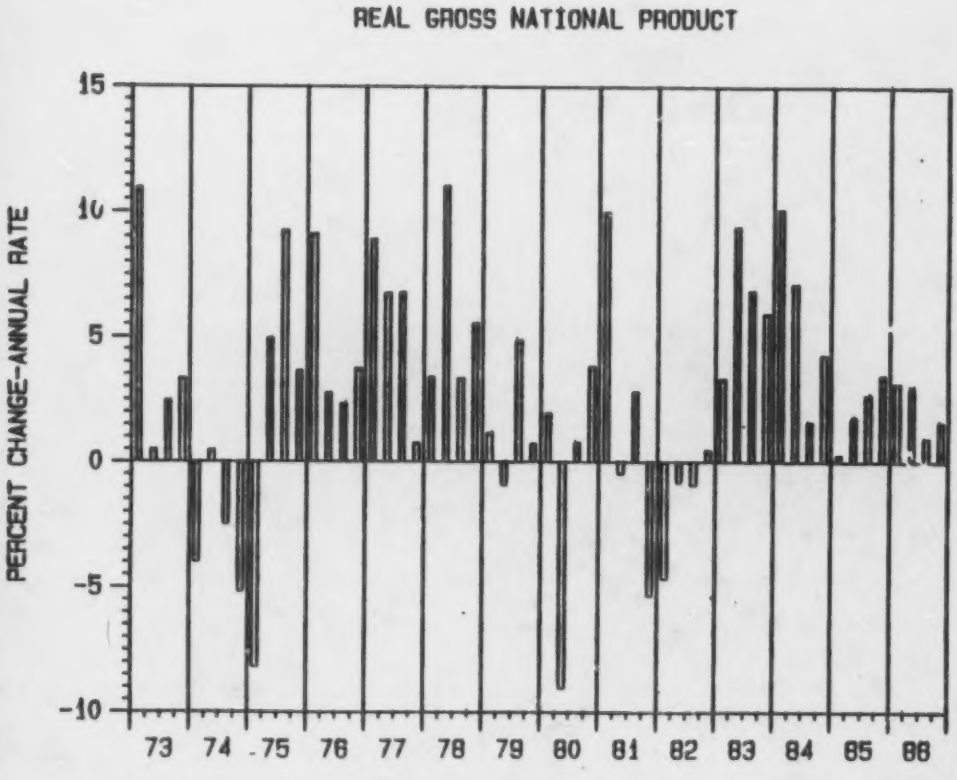
5. While a pickup in economic activity from other sources could eventually lead to stronger capital spending, it is unlikely that such spending could lead the growth process.

On balance, therefore, the outlook for the remainder of 1985 and 1986 is as follows: (a) a pickup in growth will occur later this year and in early 1986; (b) it will be relatively modest (in the 3% range); (c) growth will slow again in the latter part of 1986 as a result of some upward pressure on interest rates early next year in response to the pickup in economic growth and the likelihood that foreigners will accumulate dollar assets at a slower rate; (d) on average, the next year and a half will continue to be characterized by the same pattern of slow and erratic growth already underway; and (e) despite the slow growth outlook, the near-term risks are mostly on the downside. The outlook for GNP, and other economic indicators are summarized in **Figure 1** on the following page, and **Table 1** below.

Table 1
Forecast Summary Table
(percent)

	1982	1983	1984	1985	1986	1987
Real GNP	-2.1	3.7	6.8	2.3	2.5	3.0
Industrial Production	-7.2	5.9	11.6	2.3	2.1	3.3
Real Consumption	1.3	4.8	5.3	4.0	3.0	3.2
Real Fixed Investment	-6.8	9.7	18.0	5.1	1.8	2.6
Consumer Proce Index	6.2	3.2	4.5	3.5	3.8	4.6
GNP Deflator	6.0	3.8	3.8	3.7	3.9	4.8
Pre-Tax Profits	-25.2	22.8	14.4	-3.6	2.9	11.0
Unemployment Rate (%)	9.6	9.4	7.4	7.3	7.4	7.2
Prime Rate (%)	14.9	10.8	12.0	10.0	9.9	9.6
Atuo Sales (million)	8.0	9.2	10.4	10.6	10.4	10.8
Housing Starts (mil.)	1.06	1.7	1.77	1.75	1.59	1.62

Figure 1


REAL GROSS NATIONAL PRODUCT
PERCENT CHANGE-ANNUAL RATE
15
10
5
0
-5
-10
73
74
75
76
77
78
79
80
81
82
83
84
85
86

Major Forecast Assumptions

The major assumptions underlying the forecast are as follows:

Major Forecast Assumptions

1.	Tax Increases * (billion $)	1986	1987
	Personal Taxes	0	-15
	Corporate Taxes	0	0
	Excise Taxes	3	6
2.	Expenditure Reductions (billion $)	1986	1987
	Defense	10	30
	Nondefense	10	20
	Interest	3	7
		23	57

3. Interest Rates
   See-Saw Pattern
   Average 3 Month Bill Rates 7.5% 1985-87

4. Food Price Increases (% Change)

1985	2.0
1986	2.8
1987	4.0

5. U.S. Dollar (% Change)

1985	6.4
1986	-7.9
1987	-3.0

6. Oil Prices ($ Per Barrel)

1985	26.27
1986	24.74
1987	24.83

7. M1 Growth (% Change)

1985	7.8
1986	8.0
1987	7.2

8. International Economic Growth: It is assumed that growth in other industrialized countries will accelerate somewhat, resulting from more fiscal stimulus and lower interest rates. Economic growth in the OECD countries other than the United States is expected to average near 3.0% per year during the forecast period.

* Assumes phased-in 10% personal tax rate reduction in 1987 and 1988. Also phases-in increases in personal exemption and lower corporate tax rates, investment tax credit and state and local deductions.

Forecast Risks

I not only believe that modest economic growth on average is the most likely outcome, I believe that most of the risks are on the downside. These include the following:

1. It is possible that the trade deficit will worsen more than I currently expect, especially if more and more companies accelerate their outsourcing programs.

2. In view of the extremely low saving rate, a significant retrenchment by consumers cannot be completely ruled out for the immediate future. Such retrenchment could in fact be triggered by any further strains in the financial system, such as the failures among several thrift institutions which have recently occurred.

3. While a sharp decline in the dollar is highly necessary to restore U.S. competitiveness in world markets, a rapid decline prior to any meaningful budget deficit reduction could actually worsen the short-term outlook. This could occur because it would probably be accompanied by a reduced willingness of foreigners to hold large amounts of U.S. dollar assets--this could cause sharp increases in U.S. interest rates. The adverse effects of rising rates in the short term would far exceed the short-term benefits to the U.S. trade deficit from a falling dollar, in view of the long lags on exports and imports from changes in exchange rates.

There are also some upside risks, the major one being that oil prices may come down more rapidly than the gradual decline now being assumed. This would cause inflation to be even lower than now expected, bolstering real income and probably causing some additional small declines in interest rates.

Outlook for Inflation

Despite the strong growth in the money supply, the outlook for inflation remains very favorable. Virtually all indicators of inflation, including wage rate increases, commodity prices, etc., remain dormant or are declining. With relatively low capacity utilization rates in most industries, and high unemployment, stronger growth would not produce the kind of bottlenecks and shortages that are usually necessary for a major acceleration of inflation. True, a sharp decline in the dollar could add to the inflation rate during the next several years, but in view of

the large amount of excess capacity and the enormous supplies of materials, the increase is likely to be modest. In fact, commodity prices have continued to decline despite the softening dollar of recent months. Finally, in assessing the inflation outlook, it is essential to focus on the differences which now exist relative to the double-digit inflation environment which prevailed during the 1970s. In particular, the U.S. and world economies have greater excess capacity now than during much of that period; deregulation in many industries and the strong dollar have increased the degree of competition; oil prices are trending downward, unlike the enormous surge in energy prices experienced during the 1970s; and the underlying trend in productivity growth appears to have improved somewhat (although only modestly).

Senator ABDNOR. Well, thank you, Dr. Chimerine. As I say, it's easy to get different viewpoints on the economy.

The last witness is Dr. Bostian. We really appreciate your being here, Dr. Bostian, and we are anxious to hear from you.

STATEMENT OF DAVID B. BOSTIAN, JR., PRESIDENT AND CHIEF ECONOMIST, BOSTIAN RESEARCH ASSOCIATES, INC.

Mr. BOSTIAN. Thank you, Mr. Chairman. It's a privilege to be here. I might state at the outset that I am somewhat more optimistic than my distinguished colleagues and will hopefully outline some of the rationale.

Before getting into the specifics of the current economic outlook, let me mention a couple of brief points about trade and productivity which are topics of concern to this subcommittee.

I, like a great many other economists, strongly agree with the President's stance that the recent "mindless stampede for protectionism is a one-way trip toward economic disaster," and it's encouraging to see the presumed cooling of that sentiment discussed in the Wall Street Journal today on the final page.

There are two reasons that this protectionism sentiment seems extremely ill-timed at the current juncture. One, our timing model on the trade-weighted dollar several months ago gave a downtrend or sell indication. This is exhibit A of my prepared statement. This particular model forecasted the uptrend of the dollar in late 1980, so, while that doesn't guarantee it's correct now, it certainly argues for the credibility of the data.

Given the earlier questions about what the impact of the strategies of the Group of Five would be, if this model is correct that the dollar, of its own natural force, has already entered a downtrend, I think we are going with the wind and these intervention actions will, indeed, be successful. Of course, we hope that they don't precipitate anything too sharp on the downside.

Certainly if the dollar has peaked, that's one less reason for protectionist sentiment.

Second, if you look at the leading economic indicators of other major industrial countries—Japan, France, West Germany, Great Britain, and so forth—almost all of those leading indicators are still trending upward rather sharply, an improved performance vis-a-vis the leading indicators in this country. Certainly if economic growth overseas is beginning to accelerate, that is another reason that those markets may become somewhat more buoyant and less reason for protectionist sentiment. So I hope that calmer heads will prevail.

There is a final reason, which may seem somewhat philosophical, that we believe world trade, admitting it needs to be fair and balanced, is very, very important. If the trend toward a unitary global economy progresses, you have much greater prospects for world peace. In essence, an interdependent world economy is an economy, I think hopefully, where there's less chance of military confrontation. So suffice it to say, I think all efforts should be made to turn back the protectionist sentiment which has risen recently.

On topic of the productivity, it is our view that it is one of the most important sources of long-term or secular economic growth.

There is an annex to my statement that deals with a concept that we call productivity economics. It was a recent presentation to the Global Economy Conference of the World Future Society. It is our view, as opposed to the conventional definition of productivity, that is, output per man-hour, that the real meaning of productivity is a much broader concept dealing with behavioral patterns, entrepreneurship, and innovation. I've seen several statements from the administration, including something that Dr. Sprinkel said in assessing the impact of the tax reform proposals of the President, that there is a perception that it may change behavioral patterns in this country in a productive manner. I profoundly agree with that concept, even though it's difficult to quantify it in an econometric model.

There are a number of specific recommendations I would make on productivity. Two brief ones are: First, that there be a cabinet-level council established, of which the Secretary of the Treasury would certainly be one member, to deal with global economic policy on the same level as national security policy. In some respect, what has been happening with this Group of Five is illustrative of the type of coordinated economic policies that such a council should devote itself to.

Second, among my productivity recommendations, I would entreat everyone to go back and study the 140-plus recommendations that came from the 1983 White House conference on productivity. I was a participant in that conference which presented recommendations that, in the aggregate, have an immense degree of potential to enhance productivity growth in this country. The President spoke there and yet it only appeared on page 7 of the Wall Street Journal. There are a lot of answers in the productivity realm that are available in black and white and they are being ignored today. Suffice it to say, if we look back 5 years from now and the economy has indeed surprised the more skeptical forecasters by sustained expansion, which I think may be the case, renewed productivity growth, in the broad meaning of that phrase, will be one of the particular sources of that expansion.

Now, dealing with the current economic outlook, right at the outset I would state that our data shows no evidence of recession. Our work suggests a somewhat more optimistic outlook than has been mentioned earlier here today. How do we go about arriving at our economic forecast? We constructed some years ago a Macroeconomic Index. You can see the recent 4-year history of this in exhibit B in my prepared statement. It's composed of 25 economic indicators. They are combined in a uniform method over time. The history of the data goes back three decades. We've been doing it on a real time basis for approximately 10 years.

What is the purpose of this? All economists, in that we are human beings, tend to be affected by periods of optimism and pessimism, depending on the backdrop of a particular point in time, and I think that it is mandatory to strive for disciplined forecasting techniques that will remove emotion from the forecasting process.

The Macroeconomic Index signaled an upswing in August of 1982, 3 months before the trough of the recession in November 1982. It has never dropped down to a threshold that would signal renewed recession and, indeed, in the last couple months, the data

has started to turn upward. I have great faith in this model. It's not flawless. It has, however, historically led economic peaks by 5 months so, if you look at that historical indication, there is certainly no recession on the horizon based on the data in our Macroeconomic Index.

A few specific forecasts. I would suspect that the 2.8-percent flash GNP estimate that was just released will be revised upward. I think there is a reasonable prospect that the fourth quarter will be stronger than 4 percent, possibly as high as 6 percent real GNP growth, and that we may, with a very strong fourth quarter, come close to a 3-percent real GNP figure for this year over last year.

Our estimate for next year, which obviously is not dependent strictly on the Macroeconomic Index, but has some judgment involved, suggests a range of 4.5 to 5.5 percent in real GNP growth. I still strongly believe, despite the recent sputterings, that this is an obtainable figure.

I would suspect that we will see some inventory accumulation and the beginning some improvement in the trade deficit. As a contrasting view to what Dr. Chimerine said regarding auto sales, while I'm sure some of those auto sales were, indeed, borrowed from the future, the intriguing thing to me is when you can spur that type of a surge in auto sales from those low interest rates, it may say something about what the economy, in a macrosense, might do if interest rates were to move meaningfully lower. That's a positive sign I see in response to those auto sales.

The most significant positive aspect of the economic landscape in our view is the continued low inflation. Why is that positive? It suggests that interest rates still have a significant way to go on the downside.

I do not know exactly how far interest rates are going to move down. It has been our view of the economic world over the years that interest rates respond with a lag to changes in inflation. We are 3 years into this economic recovery. Inflation has not come back. If the bond market finally wakes up to the realization that inflation is not a reasonable fear in the immediate future, and, given what has been the case in past economic recoveries, the current situation is dramatically more positive, I think that you might see a two to three hundred basis point, or 2 to 3 percent, decrease in the overall term structure of interest rates looking out over the next couple years.

If, indeed, that happens, I think the economic growth that we will see could be very astounding. While I don't see any smooth 4 percent real GNP growth pattern because the economic world is not that unvolatile, certainly ranges of 4 to 5 percent real growth or higher, could materialize from this development.

A question by one of the Senators who is not here now was; what can be done about the Federal budget deficit? I recently had a chat in New York with economist Art Laffer, who has merit, despite some controversiality. If you do see interest rates 2 to 3 percentage points lower over the next couple years, there is a possibility of a $60 billion savings on interest expense. If unemployment comes down by 1 percentage point, there's potentially another $40 billion savings there. It hasn't happened yet, but that's because the economy has slowed. There is, however, the potential for that to happen.

I would also mention, in that it has been overlooked like the White House Conference on Productivity, the potential savings that were outlined by the Grace Commission in terms of reducing Government expenditures. There's great room for improvement there and so far there has been pitifully little movement in that particular regard.

Senator D'AMATO. Now, Professor—are you a professor?

Mr. BOSTIAN. No. As a matter of fact, I am not.

Senator D'AMATO. Mr. Chairman, I hope you'll indulge me for a moment. I want to tell you Mr. Laffer makes all these wonderful predictions about the growth, et cetera, et cetera, and I share some of them, but if you wish to help the economy in the real world, you have to reduce Government spending. That's the real world. When we start talking about these areas where cuts, that various reports have made, can be sustained, let's see them clearly. I oftentimes hear them in rather vague generalities. When we begin to examine some of those savings that have been predicted, we find that they are either illusory or that they are deeply ensconced in our system embedded with very strong public and political protection.

This is the real world, not make-believe. Excuse me for my interruption, Mr. Chairman, but I think we want to hear reality as best we can.

Mr. BOSTIAN. Your comments are well taken, Senator D'Amato. I will simply say two things: First, in both the Grace Commission and the White House Conference on Productivity——

Senator D'AMATO. If we had an economic growth of 6 or 7 or 8 percent GNP real, we would reduce the deficit by $80 billion. That's fine. I'd love to have it, but let's be realistic. Let's not just say we can grow our way out if we have better productivity. I haven't heard anybody tell me about better productivity. Did you address the drug or alcohol syndrome we have in productivity? What are we doing about it? Do you know what's taking place? Supposing I told you that you're probably losing at least 3 percent in GNP just because of the severe drug and alcohol addiction that we have in the workplace of America. What would you say about that?

Mr. BOSTIAN. I think it's probably correct and we should be doing something about it.

Senator D'AMATO. Nobody is saying anything. Supposing I were to tell you that General Motors, at their various plant installations, has as many as one out of three workers, 30 to 35 percent, with severe drug and alcohol problems. That's 3 percent annual growth GNP that we're losing annually. That's a lot of money. Are we doing anything? Are we saying anything?

We just talk about productivity and more productivity. Tell me something real. What are we talking about?

Mr. BOSTIAN. Senator, I was not in complete disagreement with you and I respect what you said. I'm just saying two things. Certainly one could be skeptical about these things. Half of these recommendations may be fantasy in terms of the real world, but I think there's also a 50-percent chance, admitting very little has been done, that if recommendations in the White House Conference on Productivity and the Grace Commission were implemented you would see some positive results, and you're just illustrating the

nature of the desperate situation which needs to be improved. But let me come back to the real world.

Senator D'AMATO. You should be a politician. You talk faster than anyone I've ever heard.

Mr. BOSTIAN. I'm practicing. I'm almost at the conclusion of my statement. Let me come back to the real world and an observation about the economy.

In studies of various economic indicators over the years, the one indicator, though many people overlook it as an economic indicator, that has the best track record is the stock market. We do a good deal of work in forecasting the equity market. Our research suggests that this leading economic indicator, despite recent doldrums, could be on the verge of a very significant upward swing. In addition to our forecast that interest rates, real and nominal, are going to trend lower, we also believe that the equity market, which plays a causal economic role as opposed to being just a passive indicator, is going to be one more hidden card in the optimistic case that is currently being overlooked.

Suffice it to say——

Senator D'AMATO. I don't know what a hidden card in the optimistic case is. Now maybe you do. I don't understand what you said.

Mr. BOSTIAN. The stock market is going up and that not only is signaling an improving economy but also if it plays a causal role in terms of improving business and consumer sentiment and increasing real wealth, it's going to help improve the economy, as opposed to just being a passive indicator. That is what I meant, sir.

Senator D'AMATO. OK. I just never heard this term "hidden card." Maybe somebody else understood that, but I didn't.

Mr. BOSTIAN. Well, it's just something that's being overlooked. When you look at the positive and negative arguments, the stock market—if, indeed, our data is right and the stock market rises significantly—is going to enhance the overall economy.

Let me conclude with one final statement.

Senator ABDNOR. I don't want to interrupt you. Senator D'Amato is going to leave me here and I want him to ask some questions here of you gentlemen. Go right ahead.

Mr. BOSTIAN. Well, I'm at my last statement right here. It's our belief that there is at least a 60–40 probability that the economic recovery that began in late 1982 could endure to the end of this decade. I know that it seems like an outlandishly optimistic forecast. It implies that you would have rotational strength in various economies of the world, that real interest rates would come down, and that a great deal of the current pessimism and uncertainty about tax reform is going to be out of the way, hopefully very soon, and that protectionist commentary is behind us.

[The prepared statement of Mr. Bostian, together with an annex, follows:]

58-623 O - 86 - 3

PREPARED STATEMENT OF DAVID B. BOSTIAN, JR.

Mr. Chairman and members of the Subcommittee, I am David B. Bostian, Jr., President and Chief Economist of Bostian Research Associates, Inc. It is a privilege to accept your invitation to state my assessment of the economic outlook through 1986 with emphasis on trade, productivity and economic growth. Given the time constraints of today's hearing, my opening statement will be brief.

However, I entreat the entire membership of the Committee to carefully study Annex "A" to my statement, a paper on the importance of Productivity Economics in a global perspective. Today, the global economy is at a critical crossroad, where policies that foster real economic activity can lead to sustained world economic prosperity, but only if the well-known

financial risks are contained along with other impediments to optimum productivity in the global economy such as growing protectionist sentiments.

Trade

On the subject of trade, let me first state that I could not agree more strongly with the recent statement of the President of the United States that a "mindless stampede toward protectionism will be a one-way trip toward economic disaster."

The 300 plus protectionist bills now before Congress can well be characterized as the "ghost of Smoot-Hawley," as a September 5th editorial in The Wall Street Journal aptly phrased the risk. That analysis by Robert Bartley is must reading, incidentally.

While protectionist legislation is always to be avoided, it seems tragically ill-timed now. It is ironic that the present wave of Smoot-Hawley sentiment is at the very time that the seemingly, ever-strong dollar is peaking.

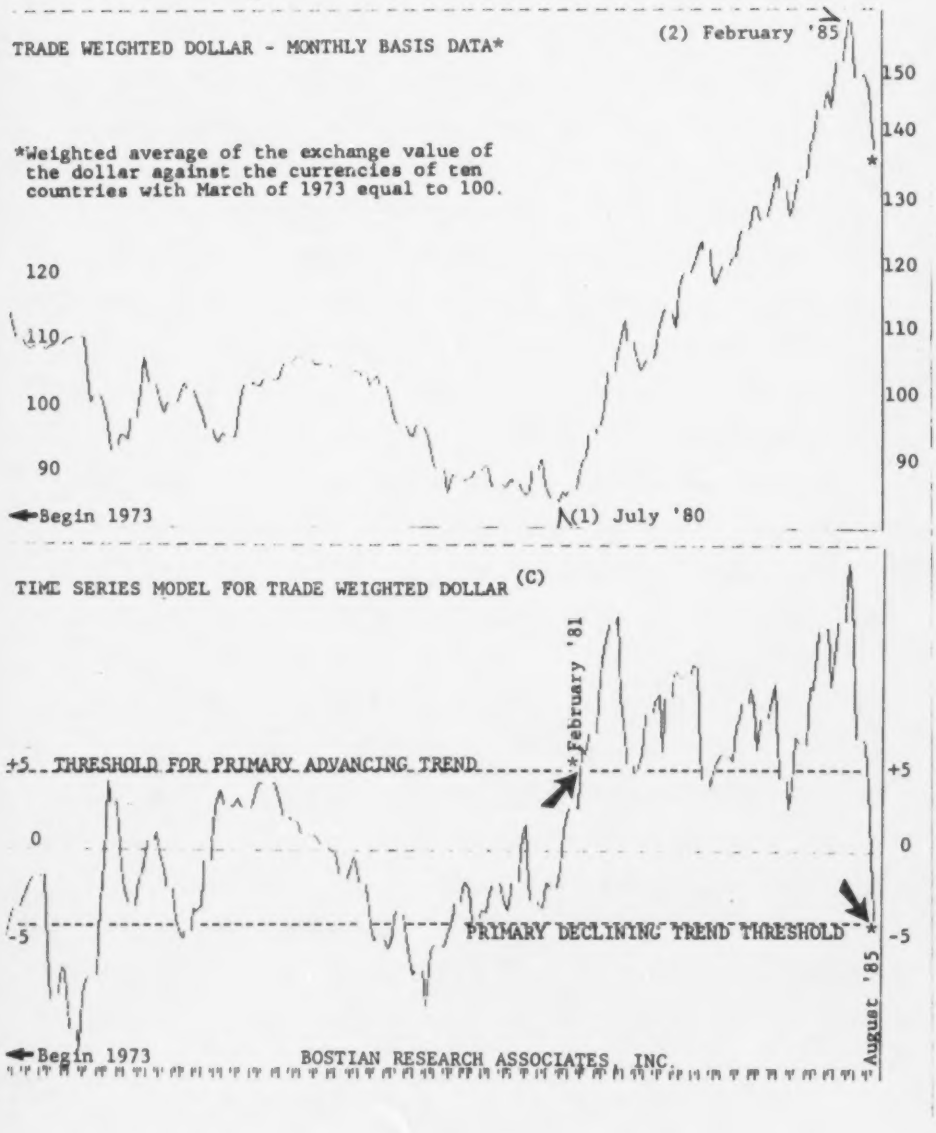
While forecasting is always hazardous, I can speak with some authority on the course of the dollar because our forecast for the trade weighted dollar correctly timed the upturn in the summer of 1980 and, more recently, the peak in the dollar in early 1985. My firm was on record, on a real time basis,

with these forecasts which were based, in part, on the data shown in Exhibit "A". Our time series model is an objective forecasting discipline using actual data on the currency as the primary input. While the trend changes in the dollar following its low in July of 1980 and apparent peak in February of 1985 were foreshadowed by divergent and parabolic behavior, respectively, in our model, the confirming trend signals for the dollar occurred in February of 1981 and in August of 1985, as indicated by the large arrows in the exhibit. While there is a one in five probability that the dollar could rise to its former peak once more, the greater probability is that the dollar is destined to decline for an extended period of time, possibly retracing more than 50% of its advance since the summer of 1980.

While the "safe haven" factor will continue to make the dollar attractive to foreign investors and while other economic influences such as the federal budget deficit and high real interest rates in the U.S. might argue against a prolonged declining trend for dollar, the dynamic of the dollar's new declining trend may be expected to take on a life of its own. Economics is as much a behaviorial science as a quantitative one.

Since the generally acknowledged overvaluation of the dollar has been identified with our large trade deficit, the prospect of a receding dollar should be viewed as long sought

EXHIBIT "A"
JOINT ECONOMIC COMMITTEE HEARINGS, SEPTEMBER 25, 1985



relief for those domestic industries that have been harmed by foreign competition.

An additional reason that protectionist legislation is especially not warranted now can be found in the fact that leading indicators of nearly all major industrial countries are signaling accelerating world economic growth. If the renewed world economic growth is sustained, as I judge it will be if protectionism is restrained, markets for our goods and services in foreign countries should become more buoyant and our trade deficit less serious. While we are all aware that some trade practices are less than fair and while there is a case for conserving our high-technology expertise, in the aggregate, this is not the time for major protectionist legislation because key fundamental trends that caused our trade problem are taking a turn for the better.

There is, however, a more encompassing rationale for resisting protectionist pressures beyond the cyclical arguments just noted. The trend toward a <u>unity</u> global economy should be fostered in every way possible because as the nations of the world become more economically interdependent, the prospects of world peace grow proportionally! World trade, of course, is vital in this quest for a more productive, less militant world.

Productivity

In the view of this witness, productivity should be the focal point of all economic policy formulation rather than just a peripheral economic concept with a narrow definition. The paper appearing as Annex "A" of this statement discusses a new paradigm which I term Productivity Economics as well as its application on a global scale. Conventional measures of productivity, based, for example, on output per manhour, have begun to wane in the third year of this economic recovery in the United States. However, there appears to be a growing world-wide recognition of a far broader concept of productivity emphasizing the entrepreneurial spirit and focusing on real economic activity as opposed to monetary manipulations.

The recommendations of my firm on the subject of global productivity enhancement ranged from establishment of a Cabinet-level Council on Global Economic Policy to an entreaty to direct renewed attention to the 148 targeted recommendations of the 1983 White House Conference on Productivity in which this witness was a participant. It is noteworthy that there even appears to be an ever-growing recognition of the importance of productivity and entrepreneurial incentives in both the Soviet Union and China!

Arrayed against the hope offered by the new Productivity Economics paradigm, of course, are the massive financial problems in the world today, including our own federal

budget deficit. I am still optimistic, nonetheless, that policies which seek to enhance real, productive economic activity in every nation of the globe, as well as free and fair trade among those nations, will result in world economic prosperity.

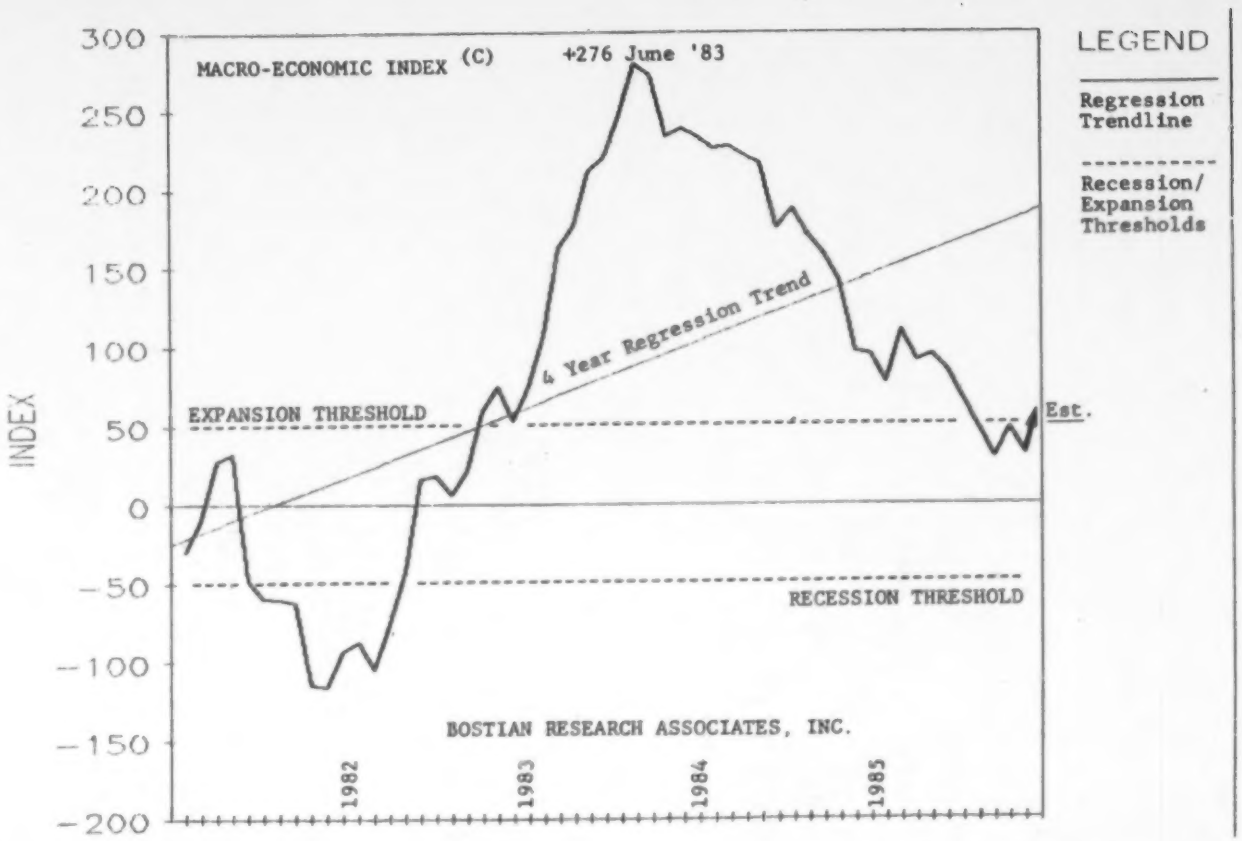
Economic Outlook - Growth Prospects Through 1986 And Beyond

The aforesaid statements on trade and productivity may have a philosophical tone, but philosophy and vision are necessary ingredients for the proper formulation of policies.

Our economic forecasting disciplines, however, have a quantitative focus that obviates any wishful thinking. Specifically, a number of years ago my firm constructed its own Macro-Economic Index to forecast cyclical swings in the economy in a disciplined manner, where emotions and predispositions would play no role. The Macro-Economic Index is composed of 25 measures of the real and financial sectors of the economy and computed on a consistent basis over time. Briefly stated, it signaled a period of economic contraction last in February of 1979 and, thereafter, alerted us to the present economic expansion in August of 1982. (The history of the Macro-Economic Index is discussed in greater detail in the concluding section of this statement, Annex "A").

Exhibit "B" is a computer generated graph of the recent 4-year history of our Index, though the data in the model

EXHIBIT "B"
JOINT ECONOMIC COMMITTEE HEARINGS, SEPTEMBER 25, 1985



extends back to 1950. A brief survey of Exhibit "B" shows that our Index soared upward well before the exceptionally strong 1st and 2nd quarters of 1984 and, indeed, was trending down decisively from its mid-1983 peak when the economy appeared strongest in early 1984, a harbinger of the recent growth recession. At no time have the data in this model come near the recession threshold in recent months. Preliminary data for September suggest that our Index is about to turn upward, indicating that, despite presently "mixed signals", the slowdown in the first half of 1985 was merely a pause before a new spurt of growth, not, as widely feared, a "last gasp" before recession. Another way of looking at the underlying strength in our Index is to note the still strong upward slope of the regression line for these data.

With regard to the outlook for the last half of 1985 and 1986, my firm expects a generally accelerating trend of real GNP growth, though, of course, quarter-to-quarter numbers are often unpredictable. The details of our forecast for 1986 over 1985, as they appear in the September edition of Blue Chip Economic Indicators, are presented in Exhibit "C" at the conclusion. Currently, we are estimating 5% real GNP growth for 1986 over 1985.

While we will, of course, be forced to revise our optimistic 1985 forecast downward should the data in our Macro-Economic

Index deteriorate, probabilities favor the case for a renewal of economic growth. My firm's judgment regarding the sector by sector details supporting this resumption of growth appear in the Annex "A" paper.

Detailed assessments of the sources of growth are of minor importance, however, compared with the most important characteristic of the economic landscape supporting our optimism, the relative absence of serious inflation. While the consumer price index has been reading 4%, the producer price index shows a level of inflation below 1%. These facts suggest that both nominal and real interest rates can trend lower in marketplace, especially if such a trend is encouraged by the Federal Reserve. My firm's record in forecasting the disinflationary climate of today is sound. Members of the Joint Economic Committee my wish to review my testimony before the Senate Finance Committee on May 18, 1981 which contained a special study detailing our case for a "Secular Peak in Interest Rates and Inflation." The tenets of that study remain valid today with the exception that the Federal Reserve should now be fostering, actively, real economic growth through lower interest rates and no longer fighting inflation. Indeed, deflation is the greater risk at this time!

If the Federal Reserve targets real (and nominal) GNP and the term structure of interest rates moves several hundred basis points lower along with one percent (or more) improvement in the unemployment rate, it is possible to project as much as $100 billion being reduced from the federal budget deficit through

savings on both interest expense and transfer payments. And a significant portion of the remaining $100 billion could be reduced from a multi-year surge in real GNP growth above 4%!

Our Macro-Economic Index status is consistent with such a highly optimistic scenario. It is my hope that those in a position to exhibit leadership in political/economic matters will formulate trade, productivity and economic growth policies that will lead the domestic and global economy along the path to sustained prosperity.

The following paper on the Productivity Economics paradigm presents our case for a world economic boom - without inflation - in greater scope.

Mr. Chairman, this concludes my statement. Thank you for your attention. I will be glad to answer questions when you are ready.

EXHIBIT "C"
JOINT ECONOMIC COMMITTEE HEARINGS, SEPTEMBER 25, 1985

SEPTEMBER 1985 FORECAST FOR 1986 SOURCE:	1	2	3	4	5	6	7	8	9	10	11	12	13	14
	Real GNP (Dec. to Dec.)	GNP Deflator (Annual)	Retail Sales (Dec. to Dec.)	Consumer Prices (Annual)	Industrial Prod. (Year)	Mfg. Prod. Capacity Utilization (Dec.)*	Non-Res. Fix. Inv. (Dec. to Dec.)*	Housing Starts (Annual)	Prime Interest Rate (Dec.)	Unemployment Rate (Dec.)*	Corporate Profits Before Tax (Dec. to Dec.)*	Housing Starts (Annual)	Auto Sales (Domestic) (Annual)	Auto Sales (Import) (Annual)
												Thousands	Millions	Millions
PETER L. BERNSTEIN	3.7H	3.9	3.8H	3.9	3.4H	4.5	10.6H	20.0H	7.8	11.6	6.5L	2.00H	8.2	2.8
BOSTJAN RESEARCH ASSOC.	3.0	4.4	3.6	4.5	7.0	3.1H	9.5	18.0	8.2	11.0	6.6	2.00H	8.7H	2.9
ECONOVIEWS INTERNATIONAL INC.	4.5	3.7	8.1	4.8	4.3	3.8	9.0	15.0	8.9	12.0	6.7	1.90	7.5	2.9
ECONOCLAST	4.4	3.1	7.5	3.2	2.1	3.8	7.2	7.8	7.0	10.7	7.2	1.92	7.7	3.3
POLYECONOMICS INC.	4.3	2.9	7.4	3.0	4.8	4.5	8.0	9.0	7.0	10.3	6.7	1.80	7.8	2.9
MARINE MIDLAND BANK	4.1	3.7	7.9	4.0	4.2	3.7	8.3	12.5	8.0	---	6.7	1.78	8.0	2.8
FAIRMODEL-ECONOMICS INC.	4.1	3.7	7.9	---	---	3.5	4.5	8.6	9.6	11.7	6.7	---	---	---
MORRIS COHEN & ASSOCIATES	3.9	4.2	8.3	4.2	4.3	4.0	5.7	13.8	8.2	11.6	6.9	1.81	8.2	2.9
HARRIS TRUST & SAVINGS BANK	3.8	4.1	8.1	4.2	5.0	2.3	5.0	10.8	7.4	9.9	6.7	1.84	8.2	3.1
U. OF MICHIGAN M.Q.E.M.	3.7	2.7	6.5	4.4	3.9	2.5	7.0	4.9	7.7	10.8	7.2	1.98	7.5	2.6
SECURITY PACIFIC NAT. BANK	3.6	4.1	7.8	4.0	4.1	2.6	4.3	12.9	8.4	12.3	7.1	1.81	7.9	3.1
LA SALLE NATIONAL BANK	3.6	3.8	7.5	4.0	4.0	3.8	4.1	7.0	7.7	11.3	6.9	1.73	7.6	2.9
IRVING TRUST COMPANY	3.6	4.0	7.7	4.5	3.6	3.9	6.5	7.8	9.4	12.9H	7.0	1.64	7.4	2.9
WAYNE HUMMER & CO.	3.6	3.5	7.2	3.7	3.7	3.4	7.0	8.2	7.3	10.1	7.0	1.72	7.7	2.6
CHAMBER OF COMMERCE OF USA	3.6	3.3	6.9	3.7	5.1	2.1	8.0	13.6	7.2	10.1	6.8	1.70	7.5	3.2
UCLA BUSINESS FORECAST	3.4	3.4	6.9	3.4	4.3	3.1	3.4	8.2	6.3	9.8	7.3	1.94	7.8	3.2
PRUDENTIAL INSURANCE	3.4	4.9	8.5	5.2H	3.3	4.1	5.3	8.5	7.6	11.6	7.0	1.80	8.1	2.9
PHILADELPHIA NATIONAL BANK	3.4	4.2	7.7	3.6	3.3	3.6	6.0	4.3	7.5	11.4	7.1	1.83	7.6	3.0
DEAN WITTER REYNOLDS	3.4	4.5	8.0	4.8	4.2	3.5	4.5	8.8	7.8	11.8	7.1	1.73	7.4	2.9
SEARS ROEBUCK	3.2	4.4	7.5	4.4	4.3	3.2	4.2	7.5	8.0	11.3	7.2	1.76	7.3	2.9
MORGAN STANLEY & CO.	3.2	4.6	8.0	4.8	3.6	2.7	3.2	7.4	---	---	7.5	1.90	8.0	2.4
CHEMICAL BANK	3.2	2.9	6.2	3.0	3.5	3.5	4.6	5.5	8.0	12.0	7.2	1.70	8.0	2.9
U.S. TRUST CO.	3.1	4.5	7.7	3.0	4.8	3.0	2.1	10.0	7.7	11.3	7.4	1.95	8.2	2.7
NORTHERN TRUST COMPANY	3.1	3.9	7.1	4.1	2.5	2.7	3.0	4.9	---	---	7.1	1.74	7.5	2.9
NAT. CITY BANK OF CLEVELAND	3.1	4.1	7.2	4.3	2.5	3.0	3.9	8.5	8.5	11.3	7.4	1.70	7.7	2.9
EVANS ECONOMICS	3.1	4.6	7.9	4.8	4.8	3.9	6.6	9.0	8.5	12.4	7.1	1.61	7.2	3.1
BROWN BROTHERS HARRIMAN CO.	3.1	4.1	7.3	4.3	2.8	2.9	2.8	8.8	---	---	7.3	1.85	7.7	3.1
PRUDENTIAL BACHE SECURITIES	3.0	2.4L	5.6	2.0L	4.5	5.0	4.2	3.2	6.4	9.6L	7.1	1.90	8.1	3.1
MORGAN GUARANTY	3.0	3.4	6.6	3.7	3.8	2.2	5.1	7.0	---	---	7.4	1.95	7.9	3.4H
CONFERENCE BOARD	3.0	3.7	6.8	3.4	4.0	3.0	3.1	8.8	7.5	11.6	7.3	1.77	8.3	2.7
BANKERS TRUST	3.0	3.8	6.8	3.5	4.3	2.7	1.7	8.6	---	---	7.1	1.91	8.1	3.0
ARNHOLD & S. BLEICHROEDER	2.9	3.4	6.3	4.0	4.5	3.7	7.8	1.6	7.8	11.0	7.3	1.76	7.2	3.0
MERRILL LYNCH	2.8	3.9	6.9	3.9	3.0	2.5	3.5	6.0	7.4	---	7.3	1.81	7.2	3.0
E.I. DU PONT CO.	2.8	3.2	6.1	3.3	3.7	3.1	3.1	7.5	6.1L	10.1	7.4	1.90	7.8	3.0
EQUITABLE LIFE ASSURANCE	2.6	4.0	6.6	4.2	2.1	2.4	4.5	1.4	6.8	10.5	7.4	1.80	7.3	3.0
CHRYSLER CORPORATION	2.6	4.2	6.8	4.3	2.7	2.6	6.0	8.0	8.1	12.1	7.5	1.70	7.0L	3.3
BANK OF AMERICA, N.A.	2.6	4.1	6.7	4.5	2.3	2.4	3.9	0.8	---	---	7.4	1.83	7.5	3.1
MONSANTO COMPANY	2.5	4.6	7.3	4.7	2.0	2.6	4.7	2.0	8.8	12.0	7.5	1.60	7.4	2.9
MEYER & ASSOCIATES	2.5	3.1	5.7	3.4	2.7	1.6	5.4	6.3	6.4	9.8	7.3	1.70	7.4	1.8L
W.R. GRACE CO.	2.5	3.7	6.3	4.2	2.9	1.7	6.6	4.1	7.4	10.7	7.5	1.70	7.6	2.8
PENNZOIL COMPANY	2.4	5.7H	8.2	5.1	2.5	2.9	3.0	5.5	10.2H	11.3	7.6	1.66	7.5	3.1
GEORGIA STATE	2.4	4.2	6.7	4.3	2.2	2.0	3.2	0.6	7.5	11.5	7.1	1.60	7.0L	3.1
EGGERT ECONOMIC ENTERPRISES	2.3	4.0	6.4	4.2	1.8	2.5	2.8	1.0	7.3	11.0	7.7	1.60	7.3	3.0
METROPOLITAN INSURANCE	2.2	4.6	6.9	4.4	3.3	2.5	0.5	5.9	7.7	11.3	7.2	1.60	7.4	2.4
MANUFACTURERS HANOVER TRUST	2.2	3.7	6.0	3.8	1.4	2.4	1.1	5.0	7.4	10.1	7.5	1.76	7.3	---
1ST NATIONAL BANK - CHICAGO	2.1	3.7	5.9	3.8	0.5	3.6	1.4	-1.6	6.5	10.6	7.9	1.76	7.3	3.2
ARTHUR D. LITTLE	2.0	4.0	6.1	4.0	-3.0L	2.0	0.0	-5.0	6.9	10.5	7.3	1.40L	7.1	2.8
CHASE MANHATTAN BANK	1.7	4.3	6.1	5.2H	1.6	2.5	2.0	-5.6	---	---	8.0H	1.90	7.2	2.8
SIPP, OAKLEY, MARKS, INC.	0.8	4.5	5.4	4.4	-0.3	1.1L	0.9	-4.8	7.3	11.5	7.8	1.65	7.2	2.9
CANNERS PUBLISHING CO.	-0.3	4.4	4.2	4.4	-2.5	2.3	-2.7L	-10.7L	7.9	11.8	7.8	1.60	7.2	2.4
BUSINESS ECONOMICS, INC.	-0.7L	4.0	3.3L	4.0	-3.0L	2.0	4.0	-10.0	7.3	11.0	8.0H	1.60	7.0L	2.3
1986 CONSENSUS: SEPTEMBER AVG.	(3.0)	(3.9)	7.0	4.0	3.2	3.0	4.5	6.0	7.7	11.1	7.2	1.76	7.6	2.9
TOP 10	4.4	4.7	8.4	4.8	5.6	4.3	8.2	13.6	8.9	12.1	7.7	1.94	8.2	3.2
BOTTOM	1.5	3.0	5.4	3.1	0.1	1.9	1.0	-3.4	6.7	10.0	6.7	1.58	7.1	2.4
AUGUST AVERAGE	3.0	4.0	7.2	4.2	3.3	3.2	4.6	5.2	7.8	11.2	7.2	1.78	7.7	2.9

BASIC DATA SOURCES:
Copyright 1985, Capital Publications, Inc.

* All Urban Consumer Items, BLS; * Federal Reserve Board; * In 1972 $, BEA; * Non-residential Fixed Investment, In 1972 $, BEA; * Corporate Profits Prior to Inventory Valuation and Capital Consumption Adjustments, BEA; * Secondary Market Bank Discount Basis, Federal Reserve Statistical Release H15; * Moody's Seasoned Federal Reserve Board H15; * All Civilian Workers, BLS; * Bureau of Census, SAAR; * Domestic Sales, annual rate. ** Import Sales, annual rate.

ANNEX "A"
JOINT ECONOMIC COMMITTEE HEARINGS, SEPTEMBER 25, 1985

THE FOLLOWING PAPER IS PRESENTED AS SUPPORTING MATERIAL FOR THE STATEMENT OF DAVID B. BOSTIAN, JR. BEFORE THE SUBCOMMITTEE ON TRADE, PRODUCTIVITY AND ECONOMIC GROWTH.

THE BRIEF PRESS RELEASE FOLLOWING HIGHLIGHTS THE KEY POINTS IN THIS ADDRESS TO THE GLOBAL ECONOMY CONFERENCE OF THE WORLD FUTURE SOCIETY ON AUGUST 8, 1985.

FOR RELEASE AUGUST 8, 1985

Marilyn Wilson & Associates

Economic Editing.

"PRODUCTIVITY ECONOMICS": THE NEW WAY TO ACHIEVE WORLD PROSPERITY

WASHINGTON, D.C. — The world is on the verge of taking a "giant step out of the Dark Ages of economic thought," economist David B. Bostian predicts.

A practical new concept that Bostian calls "Productivity Economics" is the key to global growth and prosperity, he told the Global Economy Conference of the World Future Society today.

After years on the financial-market firing line, the president of Bostian Research Associates, Inc. is convinced that a real-world approach is far more effective than "ivory tower" economic theories. "Productivity Economics," Bostian explains, "demands that all economic policies be judged in terms of their ability to encourage the worldwide production of useful goods and services."

Bostian, who has an impressive track record when it comes to forecasting the U.S. economy's ups and downs, stresses that good global policies are much more important than good predictions. "Most of my so-called 'far-out' calls have been right on target," he acknowledges. "But there is a limit to the long-term value of economic indicators — even when these indicators are correctly interpreted."

In his speech, which also outlines Bostian's upbeat outlook for 1985 and 1986, the New York-based consultant recommends seven vital policy moves that could create a long-lasting "world economic boom---without inflation."

Space technology especially offers many peaceful possibilities for innovative, entrepreneurial activity, Bostian believes. "We economists may soon have to trade in our crystal balls for telescopes," he predicts.

For further information, call:
David Bostian, (212) 907-0100 or
Marilyn Wilson (202) 331-3728

FORECASTING THE UNITED STATES ECONOMY WITH A GLOBAL PERSPECTIVE

Macro-Economic Indicators versus Macro-Economic Policy

by

David B. Bostian, Jr.

Good evening. It's a pleasure and a privilege to be part of such an exciting conference. Clearly, there's one thing we all agree on: If our nation's economy is to survive and thrive, we must learn how to mesh our goals with the interest and needs of the rest of the world. And policies that focus on productivity are, in my opinion, the key to this "win-win" goal of global economic prosperity.

As you know, my firm is heavily dependent on economic numbers that measure the impact of policies. We look at the various macro-economic indicators and try to come up with accurate predictions that will help our clients prosper -- and hopefully, help policy-makers arrive at wise decisions.

Incidentally, our track record is excellent. In recent years, the Bostian Research Associates' forecasts of the economy have

been remarkable in two ways:

First, we have often been at odds with the outlook of the consensus "pack." Second, most of our so-called "far-out" calls have been right on target.

But, I am not here to brag. You may be surprised to hear that I think there is a limit to the long-term value of economic indicators -- even when the indicators are correctly interpreted. Later on, I will describe in detail our forecasting methodology. But first, I want to talk about something of far greater importance.

As a concerned economist who cares deeply about the future prosperity of the United States, it is clear to me that good economic policies that are geared toward productivity are essential. All economic intelligence, including our own Macro-Economic Index, is simply a reflection of macro-economic policy.

Therefore, it's very encouraging to see that there is a growing, world-wide perception that productivity is the foundation of all realistic economic policies. I have termed this new way of thinking "Productivity Economics" -- and in my opinion, it signals a dramatic breakthrough for the Dismal Science.

This new focus on productivity goes beyond Supply-Side Economics and is leagues ahead of Monetarism or Keynesianism. Indeed, it is a giant step forward out of the Dark Age of economic thought,

because it's now understood that productivity means much more than "output per manhour."

Productivity Economics embraces the full, but intelligent, utilization of resources in the world economy -- as well as intangibles such as innovation and entrepreneurial trends. It demands that all economic policies be judged in terms of their ability to encourage the production of useful goods and services. Later on, I will list some specific policy recommendations aimed at achieving the global gains that will flow from this new economic approach.

As a matter of fact, we may be thinking too small when we talk about the "global" economy. The development of space-related technologies means there are untold possibilities for economic growth -- not only on the earth, but above and beyond. Once productivity is given a free rein, we economists may have to trade in our crystal balls for telescopes!

We will still be keeping our eyes on indicators, however...

Economic Indicators

Economic indicators are passive compared to the active ingredient of economic policy when it comes to achieving world economic growth. Nevertheless, indicators still offer vital insights into today's and tomorrow's economic events. One excellent source of

global economic information is the International Economic Indicators publication of the Center for International Business Cycle Research at Columbia University. Several graphs from this publication appear on Appendix pages A, B and C at the end of this paper.

These recent figures show that the leading economic indicators for the United States have lost their upward momentum in the past months. But it is noteworthy that this lost domestic vigor is offset, in part, by the growing health of eight other important countries such as West Germany, France and Japan. As the "Growth Rate" graphs on Appendix A show, the leading index composites of these eight nations are accelerating. This healthy international momentum will actually help stabilize the current slower growth here at home -- and increases the likelihood of a continued global economic recovery.

Still, the enormous impact of the U.S. economy on the world economy cannot be ignored. We are the "bellwether" nation. This is why our firm has developed a unique "Macro-Economic Index" that forecasts not only the U.S. economy but, by implication, the probable course of the global economy.

The Macro-Economic Index

Our Macro-Economic Index is composed of 25 individual economic measures, all of which have approximately equal weights. These

25 individual variables cover virtually every sector of both the real and financial economy. (See Appendix D)

Our approach to forecasting is to keep an eye on both systematic quantification of available data and decision-making. We use "time series analysis", which means that history of the variables being forecast is used as a model for future values. In contrast to econometric models, there are no "estimates" of variables in the Macro-Economic Index: only actual data are used and interpreted within the bounds of historically-proven parameters.

A graph of the monthly movement of our Index since 1970 appears on Appendix E. A table summarizing our signals of recovery and recession (Appendix F) further shows how accurate our signals have been when compared to the Index of Coincident Indicators.

As I noted earlier, our Index has often differed with the consensus as well as the official recession/recovery definitions that are dictated -- after the fact -- by the National Bureau of Economic Research.

For example, the Bostian Macro-Economic Index signaled recession in February of 1979. This signal came 11 months ahead of the officially designated peak in the economy of January, 1980. Significantly, our Index <u>never</u> validated

the brief uptick in the economy between July, 1980 and July, 1981 -- which the NBER called an economic recovery.

Furthermore, our Index did not signal a new recovery phase of the economy until August of 1982. In this call, we led the officially defined turning point in the economy (November 1982) by three months.

Since we viewed the 1979-1982 episode as one prolonged recession, our Index has had an average lead time of five months prior to the six cyclical peaks in the economy since 1953, as defined by the NBER.

Our index has been fine-tuned to be approximately coincident with economic troughs, to avoid false recovery signals.

The Macro-Economic Index as a Leading-Edge Forecasting Tool

We like to think that our forecasting method has a built-in discipline that allows us to escape the emotions of the moment and keep a more even-keeled perspective.

Yet, when our Macro-Economic Index began to soar in February, 1983, the Wall Street Journal referred to Bostian Research Associates as "raging optimists". In fact, we were uncomfortably perched at the top of the monthly "Blue Chip Economic Indicators" survey because our outlook for real GNP

growth was so far above the projections of the leading econometric forecasting firms.

We stuck to our guns through 1983, however, and continued to say a strong recovery was in the making. As 1984 began, our forecasts for real GNP for the first and second quarters of that year were close to the actual 10.1% and 7.1% growth rates.

Yet, just when the skeptics finally got excited about the strong first half of 1984, our Macro-Economic Index plunged -- so we did not raise our real GNP estimates. Suddenly, we plummeted from the top to the bottom of the Blue Chip survey in the fourth quarter of 1984 -- an event which proved to be a harbinger of the growth recession the economy is now experiencing.

It is not my intent to belittle the value of consensus forecasts such as the Blue Chip survey. The relative accuracy of consensus forecasts has been consistently validated and was even admired by the Harvard Business Review. Nor do I want to imply that our method is infallable. (I must admit that I'm tempted to boast about the fact that in October of 1983, Bostian Research predicted the 6.8% real GNP for 1984 to the exact decimal point. But that was merely good luck -- no analyst can constantly hit the bulls-eye because forecasting is not an exact science.)

However, given the exceptional volatility of the business cycle

in recent years, it can be very helpful to know where the "leading edge" of the consensus data may actually lie. Are economic conditions improving more rapidly than expected, or crumbling at a greater-than-anticipated rate? Our Macro-Economic Index, so far, has been an accurate early warning of shifts in economic activity.

Our Current Outlook: Optimistic, Despite the Risk Factors

We feel that the outlook is still encouraging, despite the fact that the U.S. will not achieve the exceptional economic growth of 1984 compared to 1983. Briefly, here are some of the highlights of our 1985 and 1986 forecasts:

- Real GNP will grow at a 3.6% rate in 1985 (this assumes a moderately strong third quarter and a very strong fourth quarter.)

- In 1986, we now believe real GNP growth will be 4.9%, well above this year's level. This forecast, which we just revised upward, is based on the belief that the benefits of interest rate declines in 1985 will start to show up next year. It also assumes continued consumer spending thanks, in part, to the positive balance sheet impact of higher financial asset prices. We also expect renewed capital investment as manufacturing

rebounds, a pickup in inventory accumulation, a reduction in the drag that comes from negative "net exports" and healthy residential construction and auto sales.

- Profits for 1985 (pretax with IVA and CCA) will probably be rather flat. This prospect may not be fully discounted in the equity market and might be the cause of an intermediate decline in stock prices. But in 1986, profits should rebound sharply with our present estimate being an 18% gain.

- Inflation is expected to remain moderate and we believe interest rates will advance only modestly through 1986. These sectors must be monitored closely, however, because a sharp decline in the dollar, for example, could have extremely adverse consequences if the wrong policy moves are made.

To sum up, despite significant domestic and international risks, I believe the economic expansion that began in August, 1982, will continue. A real economic "boom", after all, is not a super-heated economy but sustained economic growth with low inflation. The recent sharp decline in real GNP, therefore, should be viewed as nothing more than a return, on the average,

to a sustainable growth path.

If our optimistic forecast is correct, the current drop in our Macro-Economic Index ...now "plus 29"... will soon end. But in case our Index dips down to the danger level of "minus 50", you can be sure we will quickly revise our forecast accordingly.

The Risk Factors

Ideally, the movement of the 25 components of our Macro-Economic Index should reflect the overall impact of all positive and negative influences on the economy at any given time. Yet the inescapable fact is that government policy -- and the resulting economic fallout -- are critical factors that cannot be ignored, and must be assessed independent of the indicators!

Among the most troublesome uncertainties today are:

- The awesomely-large federal budget and trade deficits,
- Corporate profit margins in a disinflationary climate,
- International debt problems and a potential sharp decline in oil prices,
- A possible slide in the trade-weighted dollar that would disrupt international money flows and the risk of damaging protectionist moves,
- A deferral of business and consumer spending due to uncertainty about tax law changes.

Perhaps the greatest risk factor is Federal Reserve Policy, which may not have been sufficiently expansionary during 1984. Money growth that year (see Appendix G) showed one of the sharpest plunges on record. This single factor explains, to a large degree, the significant slowing of the U.S. economy over the past four quarters.

It may well be that the Fed's easier policy, adopted in early 1985, came too late. I myself urged Chairman Paul Volcker to shift to a more expansive policy in April of 1984. In many ways, the Fed is to be commended for its successful fight against inflation. And true, the central bank's delay in loosening its grip on the money supply can be explained by "inflation fears". But these once valid fears are proving to be goundless. (See Appendix H, "Money Growth and Inflation")

Meanwhile, the downward trend of long-term rates is a message that the financial markets believe that a secular (not just a cyclical) decline in inflation is underway.

Now the question is whether "dollar fear" will replace "inflation fear" as a new impediment to an easier Fed policy. Volcker's recent testimony before the House Banking subcommittee suggests that a further slide in the dollar might trigger further tightening. Such a move could blitz an otherwise promising outlook for the global economy and add to financial-market jitters.

As an aside, my firm recommends that corporate clients be prepared to hedge against volatility risks in the stock, bond and currency markets with various financial futures strategies.

Policies That Will Lead To World Prosperity

In spite of the already-mentioned and well-known domestic and international risks, I believe the future of the global economy is promising. But everything depends on sound policies that focus on Productivity Economics.

The importance of this approach was highlighted when the Reagan Administration sponsored the White House Conference on Productivity in 1983. I participated in that conference, which produced a staggering number of specific productivity-enhancing suggestions -- 66 for the private sector and 82 for government! The recommendations were published in a special report to the President and make very interesting reading.

My personal list of policy recommendations is almost as long, but here are the key steps I believe our government should take to help accelerate the trend toward Productivity Economics on a global scale:

1. Global economic policy should be placed on a par with national security policy. A Cabinet-level Council should be established, composed of the Secretaries of State, Commerce and Treasury.

The Chairman of the Council of Economic Advisers and other representatives of the White House should also participate.

2. In all policy discussions with other countries -- whether Communist or non-Communist -- the common value of productive economic endeavors should be strongly stressed and explored. Our position should be that cooperation is infinitely superior to confrontation, whether economic or military in nature. There are already hopeful signs that the time is ripe for such talk: Communist China has begun to experiment with entrepreneurial incentives (perhaps taking the hint from Hungary). And in the Soviet Union, Mikhail Gorbachev is emphasizing the need for greater productivity.

3. Economic aid, which is essential to developing countries, should focus on inspiring private entrepreneurial efforts instead of sending money to the governments of such nations. Direct investments (equity) rather than loans is the best way to encourage productive economic activity.

4. Instead of responding in kind, the U.S. must try to turn around the strong protectionist stance of other nations in order to foster international trade. The

goal of a unified, global economy clearly depends on policies that assure the growth of international trade, and we must take the lead in establishing a climate in which trade will thrive. This task is especially important since an interlaced world economy that is busy improving its living standards is a world that has a stake in peace, not war.

5. Domestic fiscal and monetary policies should be more closely coordinated, with a global goal of keeping the dollar at an appropriate level -- and avoiding sudden ups and downs in the dollar's value. This will ensure the balanced growth of world trade and help avoid disruptive capital flows.

6. To take the lead in Productivity Economics, America needs to start putting the recommendations of the White House Conference into action. The arena for such is vast: government policy, human resources, capital investment and research and development.

7. Finally, I believe the U.S. must, above all, start redoubling its efforts to create incentives for productivity-enhancing research and development. As I have testified before Congress, R & D tax credits for <u>all</u> industries are imperative. This

is because policy-makers cannot know in advance where and when productive innovations may occur. R & D is the fountainhead from which innovation springs and innovation is a major force behind long-term growth. It is vital that the present tax reform legislation recognizes this truth!

Innovation: The Key to Productivity Economics on a Global Scale

First, the foundation of sustained economic growth into the next century will be based on continuous capital innovation and productivity enhancement. Happily, in America there is a growing bipartisan awareness that economic policies must be judged in terms of their ability to spur the production of useful goods and services. History tells us that past economic growth was founded on such innovations as railroads, radios, automobiles, aircraft and computers.

Second, it must be recognized that the greatest innovation frontier today is the industrialization of space. Space-related technology offers untold possibilities for economic growth, both on and above the earth. The global perspective offered from the vantage point of space should convince all caring humans that the idea of "mutually assured destruction" is absurd! Just consider what might happen to the growth curve of the world's real GNP if the resources now devoted to military outlays were, even in part, directed toward productive

economic activity -- in every country of the globe and in the skies that all nations share.

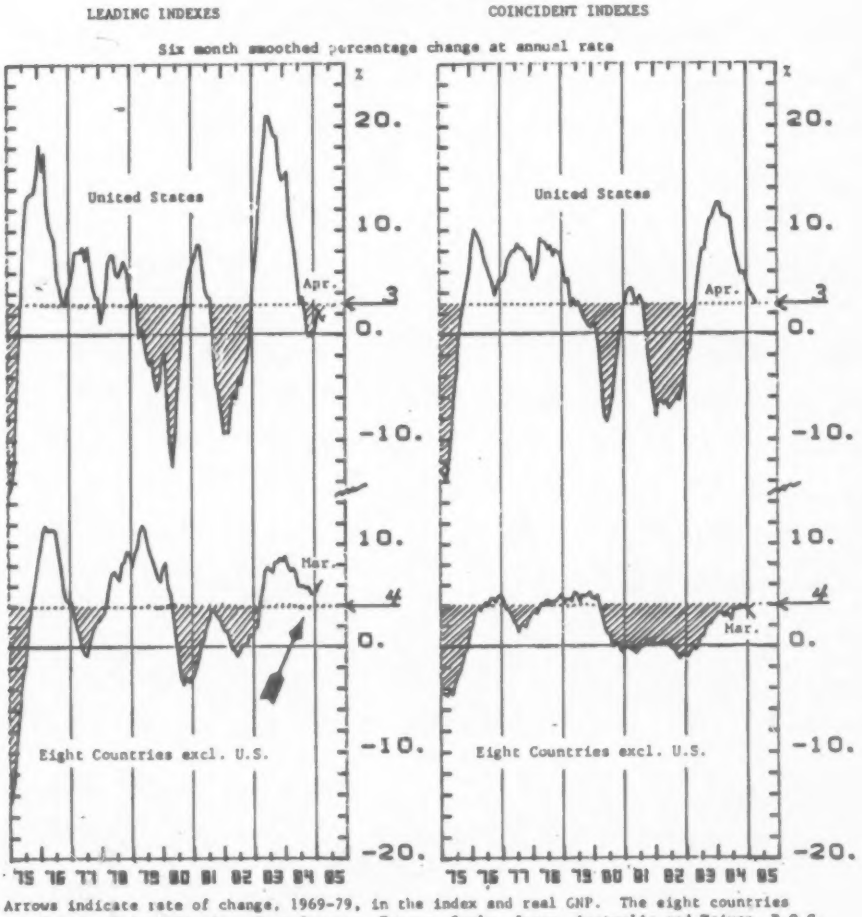
In sum, we must work to foster a common sense of world economic purpose in every way possible. Economic prosperity will be the reality of the 21st century if today's risks are contained long enough to allow the fruition of policies which will maximize the real, long-term growth of both the domestic and world economy.

It is my firm belief that traditional economic theories will someday seem as obsolete as medieval medical practices. Policies based on the new concept of Productivity Economics will create a world economic boom without inflation -- a boom that could last indefinitely, because it would be self-reinforcing.

APPENDIX A

SOURCE: INTERNATIONAL ECONOMIC INDICATORS

I. GROWTH RATES IN LEADING AND COINCIDENT INDEXES
NINE COUNTRIES, 1975-85



Arrows indicate rate of change, 1969-79, in the index and real GNP. The eight countries are Canada, United Kingdom, West Germany, France, Italy, Japan, Australia and Taiwan, R.O.C.

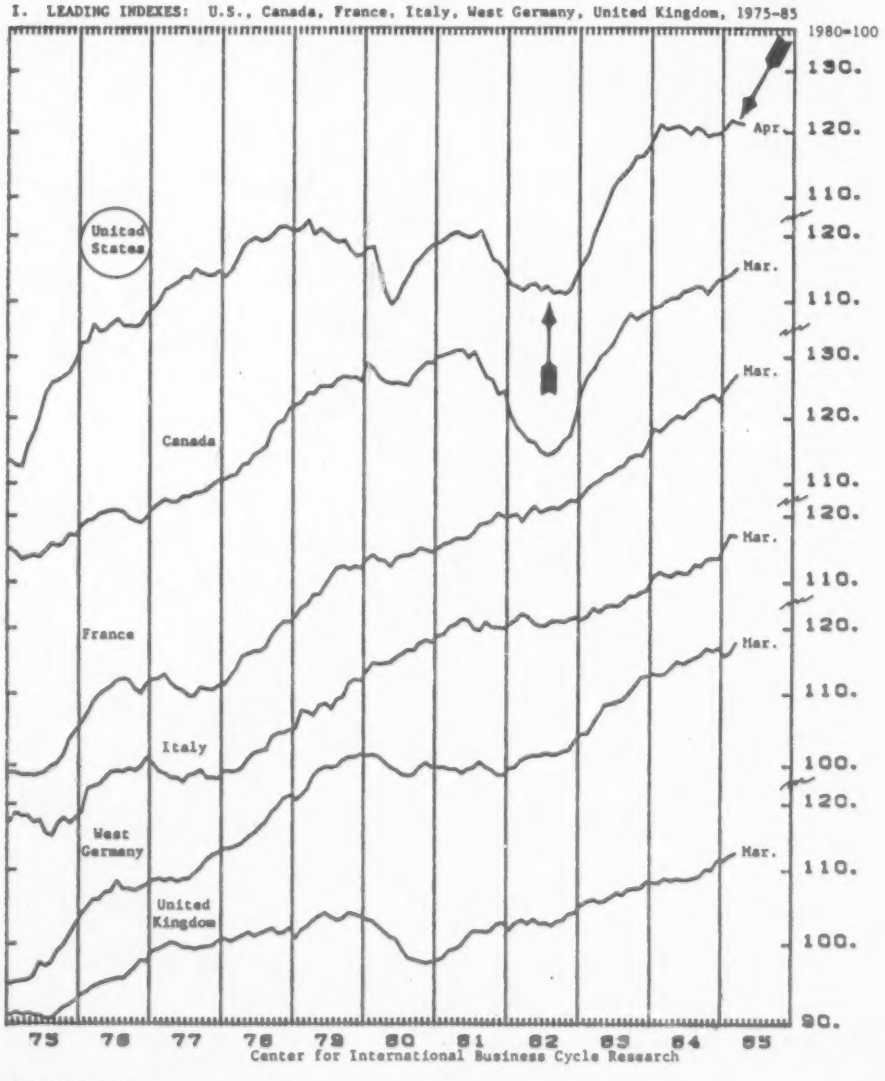
Center for International Business Cycle Research

IEI/June 1985/11

SOURCE: INTERNATIONAL ECONOMIC INDICATORS

APPENDIX B

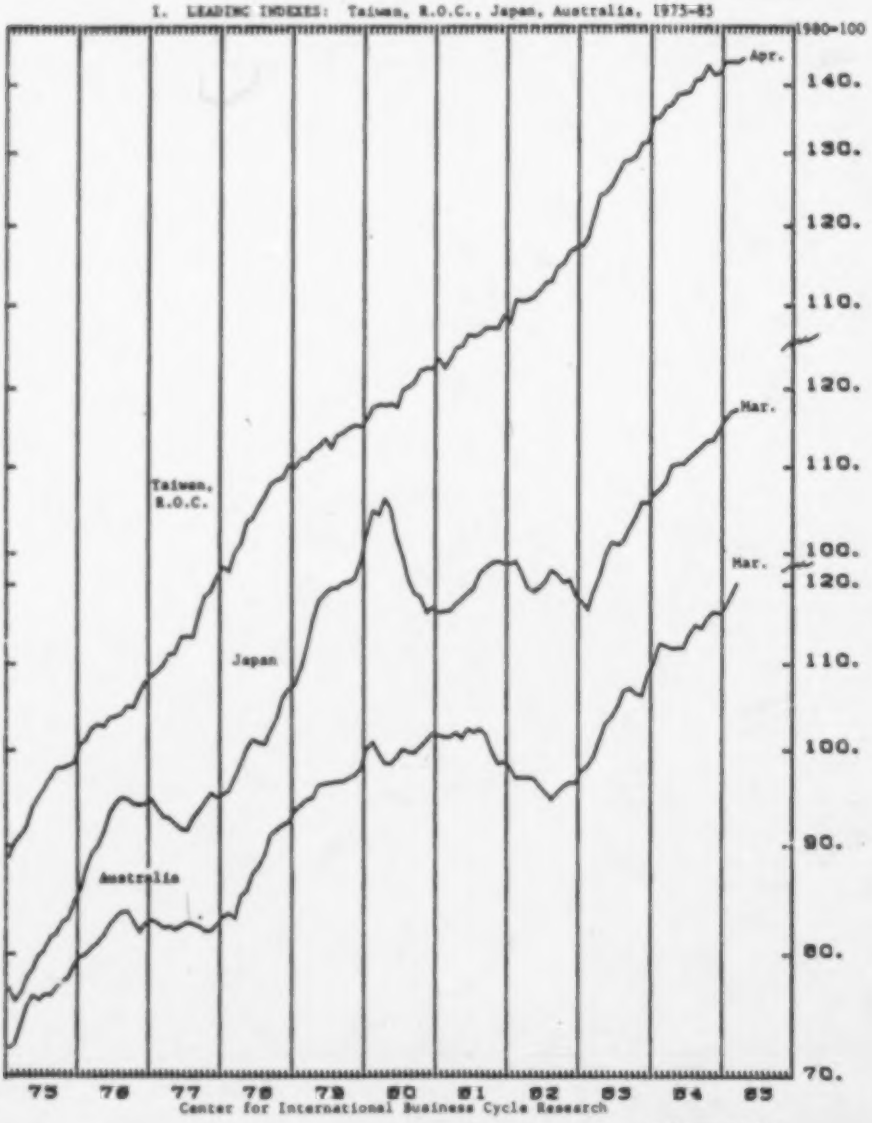
I. LEADING INDEXES: U.S., Canada, France, Italy, West Germany, United Kingdom, 1975-85



6/IEI/June 1985

SOURCE: INTERNATIONAL ECONOMIC INDICATORS

APPENDIX C



APPENDIX D

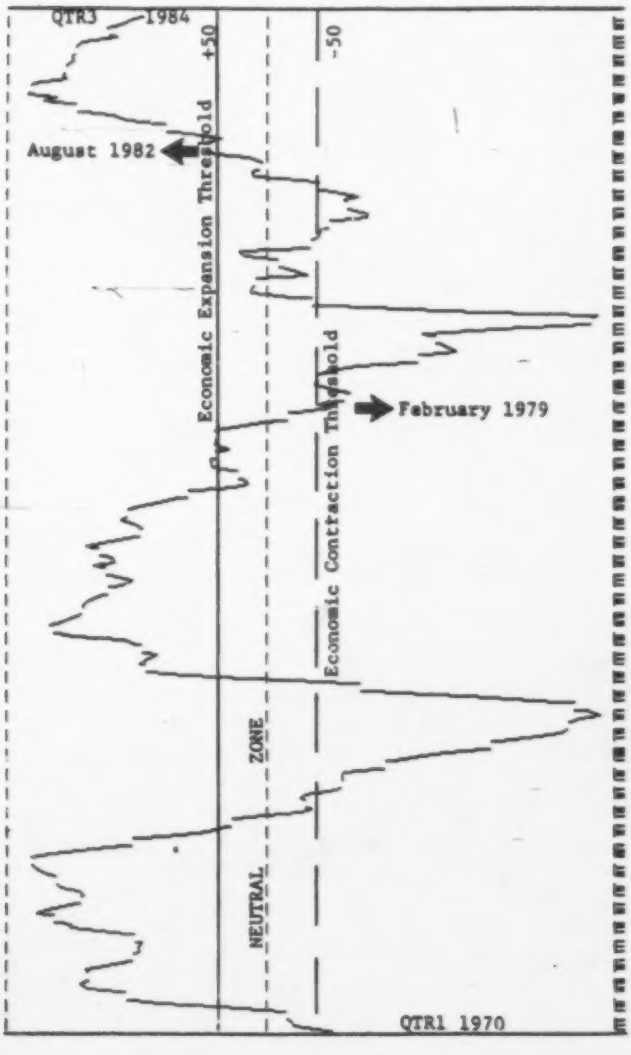
EXHIBIT PREPARED FOR JOINT ECONOMIC COMMITTEE HEARINGS, 10/4/84

COMPONENTS OF THE BOSTIAN RESEARCH MACRO-ECONOMIC INDEX

1. AVERAGE WORKWEEK,PRODUCTION WORKERS,MANUFACTURING (HOURS)
2. AVERAGE WEEKLY INITIAL CLAIMS, STATE UNEMPLOYMENT INSURANCE (THOUSANDS INVERTED SCALE)
3. NEW ORDERS FOR CONSUMER GOODS AND MATERIALS, 1972 DOLLARS (BIL.DOL.)
4. NET BUSINESS FORMATION (INDEX:1967=100)
5. STOCK PRICES, 500 COMMON STOCKS (INDEX:1941-3=10)
6. CONTRACTS AND ORDERS FOR PLANT AND EQUIPMENT,1972 DOLLARS(BIL.DOL.)
7. RATIO, IMPLICIT PRICE DEFLATOR TO UNIT LABOR COST,NONFARM BUSINESS SECTOR
8. NEW BUILDING PERMITS,PRIVATE HOUSING UNITS(INDEX:1967=100)
9. VENDOR PERFORMANCE, PERCENT OF COMPANIES RECEIVING SLOWER DELIVERIES
10. NET CHANGE IN INVENTORIES ON HAND AND ON ORDER,1972 DOLLARS, SMOOTHED (ANN.RATE,BIL.DOL.)
11. EMPLOYEES ON NONAGRICULTURAL PAYROLLS (MILLIONS)
12. INDUSTRIAL PRODUCTION,TOTAL (INDEX:1967=100)
13. PERSONAL INCOME LESS TRANSFER PAYMENTS,1972 DOLLARS (BIL.DOL.)
14. MANUFACTURING AND TRADE SALES,1972 DOLLARS (BIL.DOL.)
15. LABOR COST PER UNIT OF OUTPUT,MANUFACTURING-ACTUAL DATA AS PERCENT OF TREND (PERCENT)
16. RATIO CONSTANT-DOLLAR INVENTORIES TO SALES,MANUFACTURING AND TRADE (RATIO)
17. CORPORATE PROFITS AFTER TAXES WITH INVENTORY VALUATION AND CAPITAL CONSUMPTION ADJUSTMENTS IN 1972 DOLLARS
18. AVERAGE DURATION OF UNEMPLOYMENT (WEEKS-INVERTED SCALE)
19. RATIO,CONSUMER INSTALLMENT CREDIT TO PERSONAL INCOME (PERCENT)
20. CHANGE IN SENSITIVE MATERIALS PRICES,SMOOTHED (PERCENT)
21. COMMERCIAL AND INDUSTRIAL LOANS OUTSTANDING,IN 1972 DOLLARS (BIL.DOL.)
22. CHANGE IN TOTAL LIQUID ASSETS,SMOOTHED (PERCENT)
23. MONEY SUPPLY--M2--IN 1972 DOLLARS (BIL.DOL.)
24. AVERAGE PRIME RATE CHARGED BY BANKS (PERCENT)
25. CHANGE IN CREDIT OUTSTANDING-BUSINESS & CONSUMER BORROWING (ANN.RATE,PERCENT)

APPENDIX E

EXHIBIT PREPARED FOR JOINT ECONOMIC COMMITTEE HEARINGS, 10/4/84



APPENDIX F

THREE DECADE TRACK RECORD OF THE MACRO-ECONOMIC INDEX *

Actual Peaks and Troughs, Coincident Economic Index	Macro-Economic Index Signals And Coincident Index Levels
May 53, peak at 65	Recession signal, Aug 53 at 64
Aug 54, trough at 58	Recovery signal, Jul 54 at 58
Feb 57, peak at 70	Recession signal, Jun 56 at 68
May 58, trough at 61	Recovery signal, Jul 58 at 63
Jan 60, peak at 71	Recession signal, May 60 at 70
Apr 61, trough at 67	Recovery signal, Apr 61 at 67
Oct 69, peak at 112	Recession signal, Jul 69 at 112
Nov 70, trough at 105	Recovery signal, Dec 70 at 107
Dec 73, peak at 129	Recession signal, Sep 73 at 128
Apr 75, trough at 113	Recovery signal, Jun 75 at 114
Jul 79, peak at 151	Recession signal, Feb 79 at 149
Dec 82, trough at 132	Recovery signal, Aug 82 at 135

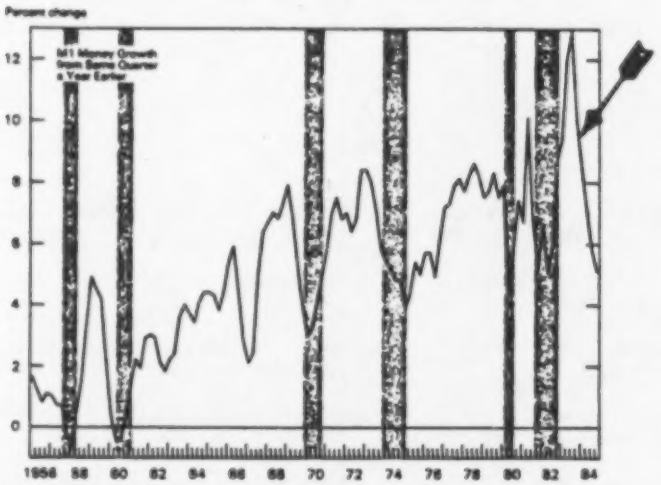
(Memo: When the Coincident Index was unchanged for two or more months at an economic peak or trough, the final unchanged month of the series was taken as the peak or trough in the table above.

*
A long term graph of these data is available on request from Ms. Geraldine Ouellette, Director of Research at Bostian Research Associates, Inc. (212-907-0178).

APPENDIX G

SOURCE: 1985 Economic Report of the President

Money Growth and the Business Cycle



COMMENTS: Peaks and troughs in the growth rate of M-1 have a clear relationship to the economic cycle. Prior to each recession (including the 1966-67 "growth recession"), there has been a sharp dip in the growth rate of M-1.

The drop in the M-1 growth rate during 1984 does explain the sharp slowing of the economy that began with the third quarter of 1984, at least in part. A concern about this negative development was cited in the Wall Street Journal credit market column on April 19, 1984 (arrow). Under the heading, "Cooling of the Recovery," it was stated:

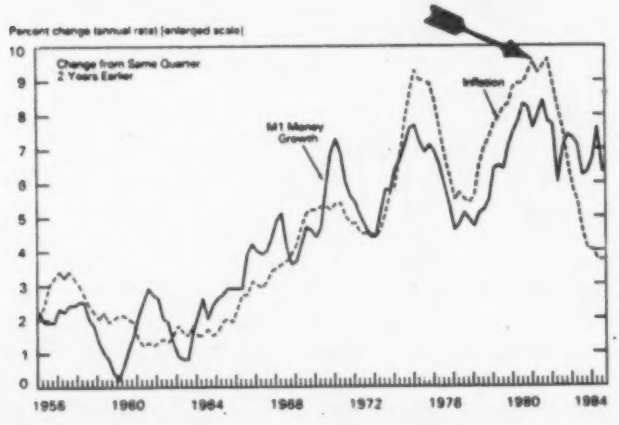
> "We're going to start seeing more and more statistics suggesting the economy is slowing down, Bostian predicted...Mr. Bostian wrote to Fed Chairman Volcker on April 3rd to say that his firm's Macro-Economic Index now clearly signals a cooling of the recovery. In the letter Mr. Bostian concluded...I must entreat you to consider a policy which will avoid turning the forthcoming slowdown into something worse."

However, monetary policy did not become more expansive until early 1985. The yet unanswered question is: did the Federal Reserve delay too long in adopting a more accommodative monetary policy?

APPENDIX H

SOURCE: 1985 Economic Report of the President

Money Growth and Inflation



Note.—Inflation measured by change in GNP implicit price deflator. Based on seasonally adjusted data.

COMMENTS: Most measures of inflation established their secular peaks in the 1980-1981 period. The GNP deflator, noted above, like other inflation indicators, has plunged to the lowest level in over a decade, severing its prior relationship to money growth rates and providing new evidence of the ineffectiveness of the Monetarist economic model.

The secular peak in inflation in the early 1980's was possible to identify, however, by reference to an array of fundamental forces then in place. In oral testimony before the Senate Finance Committee on May 18, 1981 (see arrow), the position of Bostian Research Associates was expressed as follows:

> "...we are seeing a secular peak in...inflation for a number of reasons that range from oil prices starting to recede, to the disciplinary approach of the Federal Reserve and to our assessment of the economy...which suggests that we're not going to see a tremendous explosion in credit demand..."
>
> "...you can look through Department of Commerce data, for example, and in nearly every sector of the economy see real measures of economic activity that have not made new highs since 1979..."

Senator ABDNOR. Well, thank you.

Senator D'AMATO. First of all, let me commend you in calling these hearings.

Second, I'm sorry that I missed Dr. Sprinkel while he was testifying. I had to go down to chair the Senate, so I didn't have an opportunity to put this question to him.

I see my good friend, Dr. Greenspan, is here, along with other distinguished panelists. Our last witness left off on something I was going to take up. He said, well, if we deal with this tax bill and the trade bill, that will accomplish something.

I'm wondering about the impact, but first let me make an observation. It seems to me from speaking to people in the business community that the present proposal for tax reform, and the fact that it's been going on now for a period of time, has had a detrimental impact on the economy, that indeed there has been some loss—I don't know how to quantify it, and that's why I'd like to put this question to our expert witnesses—of sustained growth that may have been achievable because of the uncertainty that the business community now faces with respect to investments. We're talking about sizable investments. I hear that various real estate development projects that go into the billions of dollars have been put on the back burner, because people are concerned about investment tax credits, accelerated depreciation, and other proposals that are contained in the present tax proposals. What impact, gentlemen, do you feel, if any, has the present proposal had with respect to GNP?

Mr. GREENSPAN. Well, Senator, I think it's had effects in both directions. The issue you raise is probably the most important one in the sense that there is the general expectation that in the event that the President's proposal with respect to accelerated depreciation is passed that the resale value of real estate properties will fall. In view of the concern that a lot real estate operators have, there's been some apparent weakening in the price structure in recent months for real estate properties. Presumably that has had some negative effect.

Nonetheless, there are other real estate projects which, because they can take advantage of a set of tax incentives which raise the effective rate of return have probably been expanded.

It's very difficult to balance these forces. But in general it's very difficult to find the shadow of the tax proposal cutting through the data. So while unquestionably its anticipation has created some uncertainties, and undoubtedly had some impact on a lot of business decisionmaking, it's unlikely to have been of a dimension where one can readily see the impact.

Mr. CHIMERINE. I would agree with that, Senator. It's obviously hurt construction of new vacation homes. On the other hand, multifamily apartment building and condominium construction in some cases has been speeded up because tax to best tax reform. The same is true in the investment community. Some large projects have been help up. Other companies have ordered equipment a little earlier than they would have because they want to make sure they get their orders in before the end of this year.

However, it's hard to see any major change in the basic underlying forces or trends in the United States. If there has been a real effect, it's been very small.

Senator D'AMATO. Mr. Bostian, do you want to comment?

Mr. BOSTIAN. My inclination, I think, would be the same as yours, that the net effect, even though it's difficult to measure, probably has been negative. Uncertainty is always bad for the economic climate.

Senator D'AMATO. What impact, gentlemen, would the proposed tax reform plan, if enacted substantially as put forth, Treasury II, have on the economy?

Mr. CHIMERINE. Well, Senator, I think if it was enacted all at once now, the total package, it would have a significant negative effect on the economy in the very short term, particularly in the areas of construction and capital spending because there isn't enough demand in these areas without the top benefits.

Senator D'AMATO. What about the long term, in terms of investments of those areas in which we seek productivity? What impact do you see in industry regarding the taking away of investment tax credits, et cetera?

Mr. CHIMERINE. I think in the long term, Senator, it would probably have a small favorable effect, but the truth of the matter is, it's very difficult to measure. It would depend upon whether or not we get investment channeled into more efficient kinds of projects rather than in empty office buildings, and, secondly, whether we get incentive effects from marginal tax rate reductions—we so far really haven't experienced any in recent years following the top cuts in 1981. My conclusion would be we can expect a small improvement in the economy in the long term, but it's very, very difficult to pin down.

Senator D'AMATO. Dr. Greenspan.

Mr. GREENSPAN. I would agree with that. What we know about the current situation is that there's a considerable amount of capital investment which does not have a prospective significant pretax rate of return, meaning that it doesn't have productivity producing capability and hence reduced labor cost possibilities, capacity expansion capabilities, and therefore, it does not have in the eyes of business management which is contemplating it, a rate of return which would be high enough to allow it to be authorized given the cost of capital.

Nonetheless, a lot of that equipment is coming forward because we have tax incentives which mean that while it may not pass muster on a pre-tax basis, it does on an adequate after-tax return. There is a substantial block of expenditures—it's difficult to know exactly how much—currently going forward which are very marginal to improving productivity or the performance of the economy. That would be eliminated. But even though such projects are not terribly productive as far as the equipment is concerned, their production creates jobs and it's creating economic activity that's measured on the industrial production index. It's measured in our GNP. In that sense, removing the investment tax credit and significantly altering our accelerated depreciation schedules would bring the economy down short term. That's what history tells us happens when you do it.

Senator D'AMATO. I have very strong reservations about the tax proposal. Number one, I think it is creating a chilling effect in certain areas, particularly in home construction. I won't discount the

fact that there may be other areas that have speeded up their activity.

Yet home construction would have been substantially better. There's no doubt in my mind. I think that has really denied us the full economic gains that could have been achieved in the home construction area. I also think there are some other very, very troubling aspects. You did touch on the fact that you reduce the value of properties, and I think that would take place nationwide. When you do away with the deduction of local property tax, home ownership becomes less desirable. There are many people who have asked me, "Senator, what do you think," because they're wondering about buying a home.

Let me ask you this. What are the three most troubling aspects of the tax proposal as put forth. I know there are many, many areas, but those three areas that give you most concern in the present tax proposal, if you could just hit them and why?

Mr. GREENSPAN. Let me start first by saying, Senator, that a revenue neutral tax proposal as complex as this is chockful with a myriad number of good provisions and a myriad of terrible provisions, and it's just in the eye of the beholder which is which.

The windfall recapture of accelerated depreciation benefits for corporations is peculiarly poor tax policy and probably would stand as number one in my view as the worst of the potential proposals.

Senator D'AMATO. Well, that's not going to pass.

Mr. GREENSPAN. I hope not.

Senator D'AMATO. That can't pass—that's a give-me. You know, if we put that up, we would frighten all of the real estate people. You know who I'm talking about—some of them are down in Texas. They would come forth and generate all their opposition. Then someone at Treasury says, "Well, OK, I'll tell you what. If you support the plan, we'll do away with the windfall recapture on accelerated depreciation. In other words, we're not going to go back and take those moneys." I cannot believe the Congress of the United States would say to people we're going to make you pay back taxes on investments that you made and income that you earned under the United States Tax Code, and now we're going to change it and say, no, you didn't earn those moneys—you have to pay them back; we made a mistake. I just don't believe that can take place. So what they'll do—they will throw that away. Why? Because then they will use that to leverage. I told some of my friends that they shouldn't sign off on this package because of that, but I agree with you. That's one.

Give me two more, Alan.

Mr. GREENSPAN. This may seem an odd one to indicate, but I think the increase——

Senator D'AMATO. What do you charge your clients for the advice I'm getting from you now?

Mr. GREENSPAN. If you ask the price, you can't afford it, Senator.

Senator D'AMATO. Anybody watching any of these, they're getting the masters here.

Mr. GREENSPAN. The real problems that we have with this bill is there are several provisions which create a problem of revenue balance. An increase in the personal exemption from a little over $1,000 to $2,000, while obviously desirable in the abstract, probably

is a use of raised revenue which is not terribly efficient. I think it should be very significantly scaled back and those revenues raised be employed to make this a revenue neutral package without doing bizarre things which I suspect the Ways and Means Committee is going to be forced into if it stays with that particular provision.

Mr. CHIMERINE. Senator, I have to say the three things that trouble me most about it——

Senator D'AMATO. Alan still owes me one. He thinks I forgot.

Mr. CHIMERINE. Then he can give you his. One of them gets at the issue of revenue neutrality. First of all, I think we ought to use tax reform to generate some more revenues to help reduce the deficit because I think, even after spending cuts, we'll need some more revenues.

But even if you don't do that, I don't think the administration proposal is revenue neutral and most of the changes you're likely to make, like changing the windfall recapture provision——

Senator D'AMATO. It's billions of dollars.

Mr. CHIMERINE [continuing]. Is going to move in the direction of making it less revenue neutral. There are also going to be other loopholes created to offset some of the revenue gains from closing existing loopholes. So, No. 1 is we cannot afford to raise the deficit, and tax reform could very well do that.

No. 2 refers to something we discussed earlier, namely the abruptness of the changes. Some of the changes like phasing out the investment tax credit or eliminating state and local tax deductions, should be phased in over several years to minimize the transition problems.

Third, quite frankly, one of the things that disturbs me about the proposal is the extremely large increase in after-tax income for upper income individuals. I have a hard time, in view of the ordering of the income distribution in recent years, accepting that. I'd like it personally, but from the standpoint of the economy as a whole, and equity considerations, I find it hard to justify.

Senator D'AMATO. Mr. Bostian.

Mr. BOSTIAN. Briefly, some of these are repetitive, certainly deemphasis of the investment tax credit and the accelerated cost recovery system has to be a major negative, hopefully only for a couple of years, assuming it were enacted.

Second, I don't see there the type of stimulus for research and development and related tax credits that perhaps should be. We believe that innovation is a primary source of secular economic growth and I don't see the research impetus in Treasury II that had been in previous bills.

Third, even though I am a homeowner and would suffer, I would be willing to accept, from a personal perspective, State and local tax deductibility removal, but would agree it should be phased out just as, for example, farm price supports, if something happens there, should be phased out. Doing something suddenly creates a brutal degree of disruption.

And I might add a fourth one, which my minister suggested that I should bring up were I to testify here at any point. Apparently there is a great deal of concern in the area of fringe benefits that ministers having their manses taxed as part of their income, along with other types of fringe benefits, would be something quite nega-

tive. Hopefully, this is not going to go through but it's a minor point that I think deserves some concern.

Senator D'AMATO. Thank you very much.

Mr. Chairman, thank you very much for holding these hearings, and I thank you for extending to me the opportunity to ask some questions well over what the usual limit is. I commend our chairman for persistently trying to bring forth the best in terms of our economists and others, so that we can have a better appreciation for what the economic situation is and what, if anything, we can and should be doing.

Senator ABDNOR. Well, thank you, Senator D'Amato. Let me say, I always look forward to the Senator coming to our hearings because he adds a real stimulant to the hearing and I had tax package questions myself but I think this has been very good. We could go on for a long time. Unfortunately, I got a card here a few minutes ago saying I'm going to be handling the Treasury bill in Appropriations when we get into regular business so something tells me I should be a little better informed on the dollars and cents in my appropriations bill and get back into the real world and try to take care of the things that are happening right now.

I want to thank all three of you. I know it was a real effort on your part to be here today and it's been very, very beneficial to us. We all hope that the economy is poised for a renewed spurt of economic growth. I can't think of anything better for Senator D'Amato, me, and others who are going into the political campaign next year. I'd like to see it for the good of the country and I'd like to see it for my own cause as well because I'm very, very concerned about agriculture and I didn't get to ask any of you three people questions. But, Dr. Greenspan, I think one of my first appearances at the Joint Economic Committee we had an overview. There were five of you here that day of all differing viewpoints and thoughts and I listened to all five and not once did I hear the word "agriculture" mentioned and I think if you go back about 5 years you might even remember that. But it has become a subject taken seriously here in this subcommittee ever since.

Mr. GREENSPAN. Senator, I'd just like to interrupt and say that I spent a good part of my early years trading wheat futures so I'm not exactly alien to your concerns.

Senator ABDNOR. Well, thank you very much. I want to again thank you all for taking the time out of your very busy schedules and I also want to say that all three of your entire prepared statements will be made a part of the written record because in some cases you've summarized here and we want them all in the record.

So with that, I thank you for coming and the hearing stands adjourned.

[Whereupon, at 11:50 a.m., the subcommittee adjourned, subject to the call of the Chair.]

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